S. HRG. 101-192

ACQUISITION OF CERTAIN RAILROADS

HEARING

BEFORE THE

SUBCOMMITTEE ON SURFACE TRANSPORTATION

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 1005

RELATING TO THE SALE, PURCHASE, OR OTHER ACQUISITION OF CERTAIN RAILROADS

JUNE 22, 1989

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ACQUISITION OF CERTAIN RAILROADS

THURSDAY, JUNE 22, 1989

U.S. Senate,
Committee on Commerce, Science, and Transportation,
Subcommittee on Surface Transportation,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:00 p.m. in room SR-253, Russell Senate Office Building, Hon. James J. Exon, (chairman of the subcommittee) presiding.

Staff members assigned to this hearing: Robert Holleyman, staff counsel; Sheryl Webber Washington, professional staff member; and Alan Maness, minority staff counsel.

OPENING STATEMENT BY SENATOR EXON

Senator Exon. The Subcommittee will please come to order.

Today's hearing raises a number of fundamental questions about the future of the rail industry. The most fundamental of these concerns the proper role of the Federal Government in regulating the industry in the public interest and to ensure a continued service.

As every observer knows, leveraged buy-outs have been occurring with increasing frequency throughout the United States economy. However, the implications of these buy-outs for the rail industry have not been fully considered by the Commerce Committee and the Surface Transportation Subcommittee.

This hearing should help us begin that inquiry as we look at the implications of increased debt incurred both from without, by the way of takeovers, and debt incurred from within in the form of corporate restructurings or actions taken to prevent takeovers.

Today's hearing will also provide a record regarding S. 1005, legislation introduced by Senator Harkin and co-sponsored by Senator Pressler, a member of this Subcommittee.

S. 1005 would give the ICC jurisdiction over noncarrier acquisitions of Class I rail carriers. The ICC currently has statutory authority to approve transactions in which a rail carrier proposes to acquire another rail carrier and where a person who is not in the rail business proposes to acquire two or more carriers.

However, the Interstate Commerce Act does not provide clear jurisdiction in cases where a noncarrier is acquiring a single rail carrier, regardless of the size of the carrier being acquired.

The Harkin proposal seeks to address this by providing the ICC with authority to review all acquisitions of Class I carriers and by establishing a public interest test for their approval.

The original driving force behind today's hearing was a proposed takeover of the Chicago Northwestern Railroad by the Japonica

Partnership. While the proposal is no longer before us due to an agreement reached which will require ICC approval of another merger involving the Blackstone Group, I believe today's hearing remains a very timely one.

With an increase in the buy-outs of the rail industry, and legislation moving in the House and S. 1005 before this Committee, I am certain that we will continue to confront the issues that are subject to this afternoon's hearing.

If Senator Kasten has not arrived by the time I complete this brief statement, we will call on Senator Kasten when he arrives. Senator Kasten as the ranking member of the Committee usually has an opening statement and I am sure that he will be here to quiz the witnesses.

I might add that the Federal Railroad Administration was also invited to testify at today's hearing along with the scheduled witnesses. However, the FRA declined to do so since, as I am told, the Department of Transportation has not yet formulated an overall policy concerning mergers and other laws in this area.

[The bill follows:]

101st CONGRESS
1st Session

S. 1005

Relating to the sale, purchase, or other acquisition of certain railroads.

IN THE SENATE OF THE UNITED STATES

May 16 (legislative day, January 3), 1989

Mr. Harkin (for himself, Mr. Pressler, Mr. Simon, Mr. Grassley, and Mr. Daschle) introduced the following bill; which was read twice and referred to the Committee on Commerce, Science, and Transportation

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A BILL

Relating to the sale, purchase, or other acquisition of certain railroads.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Subsection (a) of section 11343 of title 49, United States Code, is amended by adding at the end thereof the following:

"(7) acquisition of control of a Class I railroad carrier by a non-carrier, the result of which may produce a significant diminution or deterioration of service to be provided by the carrier, or which may increase the debt of the acquired carrier and adversely affect the ability of the carrier to provide an adequate level of service consistent with the public interest.".

SEC. 2. For purposes of the amendment made by the first section of this Act, any purchase, sale, or transfer of a Class I railroad is deemed to be a purchase, sale, or transfer by a carrier providing transportation subject to the jurisdiction of the Interstate Commerce Commission under subchapter I of chapter 105 of title 49, United States Code.

SEC. 3. The effective date of this Act shall be May 16, 1989.

○

Senator **EXON**. At this time we are very pleased to recognize the author of S. 1005. We are very pleased to have you with us today, Senator Harkin, for any comments that you care to make, and I congratulate you for introducing this bill and we are very pleased to receive it and study it in this Committee. Senator Harkin.

STATEMENT OF HON. TOM HARKIN, U.S. SENATOR FROM IOWA

Senator **HARKIN**. Mr. Chairman, thank you very much for those kind words and I want you to know how much I appreciate the opportunity to testify at this hearing on S. 1005 and the debilitating effects which leveraged buy-outs have on railroads.

I do not want the opportunity to pass, Mr. Chairman, without recognizing your strong, stalwart position in terms of fighting to provide quality rail service all over this country and especially in our rural areas of America.

Indeed, you have been the person who has stood up for the rights of those of us who live in rural America to have the same kind of rail service and adequate rail service for our farmers and for our small manufacturers and for our small communities, as do people who live in large, urban centers.

Mr. Chairman, I just want to, as a neighbor to the East, to thank you for your great leadership in this area. You have just been wonderful.

Senator **EXON**. Thank you, senator.

Senator **HARKIN**. I also would be remiss if I did not mention that Senator Pressler has been involved in this issue and I want to commend him for his work on the question of ICC jurisdiction over rail acquisitions. I have worked very closely with Senator Pressler and I know of his leadership and interest in this area.

Mr. Chairman, this is a most important subject for the rail industry and for the economic health of the entire Nation. Later in the hearing, Mr. Chairman, you will be hearing from Darrel Rensink, the Director of the Iowa Department of Transportation.

I would like to commend the Iowa DOT for its excellent testimony and insight and its important analysis of this problem. The Iowa DOT has an excellent professional staff with considerable expertise in rail issues and I commend them to you with their testimony and for any questions that you might have for them.

On May 16th, Senators Pressler, Simon, Grassley, Daschle and I introduced S. 1005. At that time, as you said in your opening statement Mr. Chairman, the CNW was facing possible acquisition by the Japonica partners. Had they succeeded in purchasing this the rail service in my state and throughout the CNW system would surely have taken a very severe blow.

Well, the Japonica buy-out, again as you pointed out, is no longer in the offing. But I am still concerned about the new purchase offer that is pending. Some of the provisions of the new bid, including the guarantee of increased equity and the commitment to track maintenance, relate more favorably to the continued operation of the railroad.

However, we must note that this new proposal was forced by the Japonica offer and again, all things considered, I do not believe that this transaction would be in the best interest of shippers in my state and in the entire area served by the CNW.

In any event, my concerns about leveraged buy-outs by railroads is not limited to just this one transaction. This is indeed a national issue with implications for rail service across the country.

I might say, this is the tip of the iceberg. This one will surely be followed by others. Railroads are crucial to the movement of agricultural goods, manufactured goods, coal and many other products.

Their maintenance and continued operation at a proper level of service are essential for our national productivity and our national security. The Nation's railroad and highway systems are the arteries and veins that facilitate commerce.

Again, just a little history here. As you know, Mr. Chairman, back in the 19th Century we granted large tracts of land to railroads. It represented a great transfer of wealth to an industry that was recognized as essential to the development of our Nation. Over 130 million acres were transferred to railroads. Over 200,000 square miles of land.

In my own State of Iowa, 4.7 million acres of land were given to the railroads from 1856 through 1864. It was an important investment and it was a key to the economic development of the country.

Mr. Chairman, I have read about the legislation surrounding the granting of the land to the railroads. I will not say that I read the debates concerning it, but if you read some of the preambles and why they were giving this land to the railroads, even though the Federal Government transferred title, what they basically said was that they were giving this land to the railroads to be held sort of in trust for the people of this country so as to build the railroads out there to serve those parts of the country.

So I believe that the railroad industry has an obligation to the people of this country that came with the transfer of that land that many years ago.

Now, for the public interest to be properly served, I think the ICC needs to examine all class I rail acquisitions. At this point, the ICC has primarily focused on one question. Is an acquisition anticompetitive?

Well, that is important of course. However, there are other key questions that should also be asked. Is the nature of the transaction such that it will result in a significant reduction of rail service?

Secondly, will increased debt from an acquisition result in a deferral of line maintenance work? Third, will deferred maintenance result in reduced usage and higher operating costs? Well, if the answers to these questions are yes, then will the result not be proposed abandonments?

It is the ICC's obligation, in my view, to the extent possible, to consider all of these questions at the beginning, at the point at which an acquisition is proposed. The ICC must not allow itself to be placed in a position of examining a fait accompli at abandonment hearings, something that has already been effectively accomplished and there is nothing they can do about it.

Frankly, I think the ICC has construed its existing authority in a most narrow fashion. Under S. 1005, the ICC could apply 49 USCA 11344(c), which simply states, and I quote,

> The Commission shall approve and authorize a transaction under this section when it finds the transaction is consistent with the public interest. The Commission may impose conditions governing the transaction.
>
> When the transaction contemplates a guarantee or assumption of payments, of dividends or of fixed charges or will result in an increase of total fixed charges, the Commission may approve and authorize the transition only if it finds that the guarantee, assumption or increase is consistent with the public interest.

That is the wording of that paragraph. Again, Mr. Chairman, I do not think that we—none of us want to return to the pre-Staggers days of nitpicking little regulations. But I do believe that the ICC should examine acquisitions of major railroads to determine whether they serve the public interest.

There are situations under which a merger should be allowed to proceed. Specific circumstances of a railroad may demand it. For instance, we have to consider whether a merger might improve a railroad's ability to raise additional capital. This is an appropriate question for a regulatory body to ask. But the ICC should look at the needs of shippers and the interests of the public at large. The ICC cannot be blindfolded by technical legal questions, like what is it that's being purchased—railroad holding companies or the railroads themselves. The ICC must look at the substance of an issue, not just its form.

Now, leveraged buy-outs were not causing serious problems prior to 1980. However, from 1983 to 1988 American corporations have doubled their debt. In 1988, U.S. corporate net worth dropped by over $300 billion.

We are now facing what may become a major crisis that would adversely affect this country's infrastructure. If railroads lose considerable equity, there resilience and ability to withstand economic downturns will be diminished and if that occurs, the very competitiveness of our Nation will be hurt.

We are facing what may become a major crisis that would adversely affect this country's infrastructure and pose a serious threat to our ability to move heavy industrial materials and grain.

If railroads lose considerable equity, their resilience and ability to withstand economic downturns will be diminished. And, if that occurs, the very competitiveness of our nation will be hurt. Areas directly affected by the loss of or a sharp deterioration in rail service will be devastated. Even those who take an ideological position against regulation and believe that a totally free market is best are concerned about the possible future costs to the government if rail service deteriorates. The U.S. government provided 130 million acres to get our railroads going. The government spent a fortune to keep Conrail going. If we allow major deterioration of our railroads, the taxpayers of our country will be forced to pay again.

The Burlington Northern is also a very important railroad in my state and in many states. By some standards, it is our nation's largest railroad. In a series of complex reorganizations, the railroad or its holding company managed to separate its huge natural resource holdings into an unassociated company, effectively transferring the natural resources-associated debt to the railroad. The railroad was left with $2.5 billion in debt derived from the natural resources portion of the company. While the Burlington Northern Railroad is still healthy, it is not nearly as economically resilient as it was a few years ago. The law should require the ICC to consider major railroad corporate restructurings like these.

Not long ago the taxpayers invested over $7 billion in Conrail. A major justification of the rather low bid that was taken was the logical desire to see Conrail leave government hands with very little debt.

Now, what do we find? We find that Conrail could soon be the subject of a leveraged buy-out which would likely wipe out most of its net worth and place it right back into financial jeopardy.

Now, according to the ICC's current way of thinking, Mr. Chairman, the leveraged buy-out would be none of its business, but it would consider individual line abandonments that could follow.

Well, I think, Mr. Chairman, this is just simply illogical public policy for them in the beginning to say, I am sorry we should consider leveraged buy-outs and what the implications of that may be down the road.

The leveraged buy-out goes ahead. The debt increases. The maintenance decreases. The costs go up and the railroad says, okay, now we have to abandon some of our lines, and the ICC says, okay, now we will take a look at it. The ICC ought to take a look at it in the beginning to see what the effects of that leveraged buy-out may be.

So again, the legislation that we have proposed is designed to provide proper regulatory oversight of rail acquisitions. I know that Chairman Dingell and others have proposed some refinements which have been passed by the Energy and Commerce Committee.

I would agree that we need to set time limits on consideration of these issues, but in view of the ICC's reluctance to involve itself in these important concerns, I urge that the Committee pass legislation which not only clearly outlines ICC jurisdiction but also specifically requires that the ICC fully consider the public interest and the effects of increased debt in proposed acquisitions.

I repeat, in proposed acquisitions, whether it is a leveraged buyout from the outside or whether it is the management taking it over—in all proposed acquisitions and in all major reorganizations of Class I railroads.

So, Mr. Chairman, that really is the sum of what I wanted to ask today.

Mr. Chairman, thank you very much again for extending me the kindness to be your lead-off witness today.

Senator EXON. Senator Harkin, thank you very much and let me once again thank you for your keenness and awareness at jumping into this issue and showing the leadership to introduce S. 1005, which we are considering here today.

I have a question or two that I would like to ask you before you leave. First, I would like to say that the excellent commentary that you have just made, it seems to me, is likely to follow with something rather important happening in this area.

I believe that we are going to receive testimony today from the ICC that indicates that they believe something along this line is necessary to give them the authority, which they do not believe that they have now. At best, the type of legislation you are sponsoring will allow the elimination of a cloud as to whether or not the ICC does have that authority.

I cannot agree more, and I would like to underline the basic statement that you just made. Those of us who have not only the privilege and the opportunity to live in the rural center part of this Nation recognize perhaps better than any others how important the railroad industry is in tying our states and the communities within our states together, and how important they are to the very basic, economic livelihood of our states.

I agree that we have to give the ICC more authority than they have now in this area, or else we are going to see more of these attempted leveraged buy-outs which to a large degree, in my opinion, do nothing to improve rail service and probably. In most instances these buyouts have the opposite effect. We would see the corporate raiders coming in to seize and sell some of the more saleable assets of the railroad and then, as you so well pointed out, apply for abandonment of certain trackage that truly devastates rural America.

I think your discussion and the remarks I made in my opening statement and the remarks that I just made probably to a large extent answer the first question that I would like to ask you, but I think it is important that we get it on the record.

The question is this. When you introduced S. 1005, the Chicago and Northwestern Railroad was faced with a possible takeover which did not appear to require ICC approval. Now that has changed and under the new arrangement, as I understand it, which has been negotiated with the Blackstone Group, they are required to gain approval and are fully under the ICC's, jurisdiction under the current law.

I assume that you feel that just because this one proposition has been properly addressed, we still need to proceed with an S. 1005 to make sure that this does not occur in the future, as it most likely will if we ignore the issue.

Senator HARKIN. Precisely, Mr. Chairman. You have hit the nail on the head, and as I tried to say in my testimony we cannot just look at this one transaction and say well, that is taken care of. We do not have to worry about it.

It is going to come up time and time again and as I mentioned in the Conrail situation, that is likely to happen and so absolutely, Mr. Chairman, I believe that this legislation is necessary.

Senator EXON. I suspect, as much as anything else, the introduction of S. 1005 by you, Senator Harkin, did as much as any one other thing to stop that takeover that you and I and others felt would be very adverse to the interest of Iowa and even more importantly, Nebraska.

Senator HARKIN. Thank you.

Senator EXON. I have another question on labor protection. We are going to have testimony today, as I understand it, that S. 1005 would require the imposition of mandatory labor protection when a noncarrier seeks to acquire a Class I carrier, whereas under the related House measure labor protection would be discretionary. Do you have any comments on this?

Senator HARKIN. Well, again Mr. Chairman, I believe that labor retention is a very important concern. It is a great concern I know of yours, and of mine too.

But we have to recognize the realities of the situation. We cannot allow the fact that certain things have been done a certain way for so many years that we are just going to continue to keep doing it that way. I understand that.

But again, I would just say that this is a question I am sure which the Committee would address when you mark up the legislation. I leave it to your best judgment and the Committee's best judgment on how best to address this problem of what you do about this question.

Perhaps, some railroads can generate with fewer people, making it more efficient. People who have worked a long time, they have started to raise families, maybe. They have got kids in school. They have got home mortgages. They have got all these other obligations and in many cases, especially when you are dealing with the railroads, they may be in a locality or in a place where there may not be equal or comparable types of jobs.

So it is an important issue. I am not an expert in this area of labor retention and job retraining, but I would just say to the maximum extent possible, labor protections need to be built in, but also provisions for retraining and replacement, relocation of those existing jobs wherever it would be best.

Senator EXON. Thank you, Senator Harkin. I have one last question. As one who has been a leader in this area and basically understands it from an economic standpoint, how would you respond to the witnesses who will be testifying later today that additional debt can result in more efficient railroad operations and that additional regulation in the form of S. 1005 would serve to discourage new investments in the rail industry?

Senator HARKIN. I would answer that by saying that railroads are different than RJR Nabisco or—I am trying to think of some of the other leveraged buy-outs we have had recently, all of the different companies that have been absorbed and increased debt loads and that sort of thing.

I may not particularly like that either, because I think a lot of these acquisitions have made our economy very brittle. I am saying that in railroads you have an overriding special public interest that ought to come into play here.

You see, it is not that railroads are losing money. They are making money. I have seen, and I will bet you have, too, Mr. Chairman, lines that have been abandoned that really were making money but the railroad could sell off all the assets of that line, take that money and invest it in junk bonds and make a lot more money than what they were making on the railroad.

But what does it do to the shippers along that line—the elevators, the farmers, the small towns that are along that line? If they are losing money, that is one point, but if they just want to make more money off of the investment they have then that is a different point.

Again, as I pointed out, we gave all of this land to the railroads in the past and I think there is an obligation on the part of the railroads and on the part of the ICC to have to consider that public interest aspect.

I do not think it is enough to say that, well, you know, we can make more money on this railroad by doing other things. I think we have to look at the irreplaceable service that it provides.

I am not saying that in no cases should there be no debt increase. That is not my position. I want to make that very clear, Mr. Chairman. I am not saying, never any debt increase. That might in some cases lead to better management.

What I am saying is, the ICC should first and foremost, at the beginning, take into consideration the public interest, what the effects of that increased debt load might do to the service, to the lines of that railroad.

If, in their judgment—and that is why we have the ICC, to make these judgments. If in their judgment the increase in that debt load will not harm the maintenance and the operation of those lines, will not lead to track abandonment, then that might be perfectly permissible to allow that for, as they say, better management.

But if the debt is such that the ICC in its judgment can say, wait a minute, this is going to cause a lot of deferred maintenance. We don't know if the railroad can make it with that debt load. The ICC shall sit this management down and say look, you are proposing to increase the debt by so much on this railroad.

How are you going to service that debt? Let me see your operating revenues? Can you service that debt out of operating revenues? If you cannot, how are you going to service it? What are you going to do?

Now, let me see your operating costs. What does it cost to operate your lines out there? What is your maintenance cost? How does that factor into that increased debt load?

I just think through the ICC's ability with their staff and counsels and everything they could look at that and make a reasoned judgment as to whether or not the increased debt load is one that can be handled by the railroad, which would provide for more efficient management, or is it one which simply will promote the abandonment of lines and the cutting off of service?

Senator EXON. Thank you, Senator Harkin. One of the things I might say that attracted me to S. 1005 is the fact that all you are providing herein is to give the authority to the ICC to take a look-see at what is going on.

Senator HARKIN. That is basically it.

Senator EXON. And we probably could not make a case for this type of legislation in Nabisco or any one plant or in one corporation with many plants around the United States. But, to a large extent, as I think you very eloquently pointed out because of the past history and because of the grants to the railroad and because they are an integral part of not just one plant, but maybe all the plants in a state. Therefore, we have to have and should have some involvement by the ICC to take a look-see before we have unfriendly takeovers who may have no interest whatsoever in developing a railroad, but rather to raid it.

Senator HARKIN. That is exactly right.

Senator EXON. Thank you very much, Senator Harkin, and we appreciate your coming over and giving us a fine explanation of your bill.

Senator HARKIN. Thank you, Mr. Chairman.

Senator EXON. We will now proceed with the other witnesses.

As our next witness we are very pleased to have, Ms. Heather Gradison, Chairman of the Interstate Commerce Commission.

Chairman Gradison, if you would please come forward at this time. You have been before this subcommittee on many occasions. We are very glad to have you here once again.

Certainly I know that you have done considerable study in this area, and we are looking forward to your testimony now.

I would first say that your full statement is very much appreciated by the subcommittee. We will accept your full statement as a part of the record without objection, and I would very much appreciate your summarizing, if you would, at this time.

STATEMENT OF HON. HEATHER J. GRADISON, CHAIRMAN, INTERSTATE COMMERCE COMMISSION

Ms. GRADISON. Thank you, Mr. Chairman. It is very good to be with you today.

Our testimony makes five main points. First, rail carriers are not altogether unlikely candidates for restructuring through the addition of debt to their balance sheets—either through outside buyouts or internal refinancing.

Second, the addition or more debt is not necessarily bad nor is it completely benign. There is no reason to believe that rail industry debt will remain at its current low levels.

Third, the commission claims no special insight into the LBO debate, but the potential commitment of public monies to the rehabilitation of dilapidated rail lines is a special consideration. It is an added reason to be certain that nothing is done either by over-regulating or under-regulating that would contribute to a return to a poorly capitalized rail system.

Fourth, the commission's jurisdiction does not include clearcut authority to regulate all forms of leveraged buyouts.

And, fifth, should the Congress decide to expand commission jurisdiction, the commission believes that some modification to either S. 1005 or H.R. 2364 would be strongly advisable.

So far this year we have seen the acquisition of the Illinois Central by a new group of investors. We have seen several offers made to buy the CNW through leverage, and we have seen a major stock buyback by the Union Pacific.

There will be more to come, though I do not see a stampede. We appended a table to our testimony showing how low the rail industry's debt leverage is compared with other commercial sectors. Rail carriers could, over time, move more toward the mid range of leverage if they become comfortable with the range of stability in their markets and their earnings.

What concerns the Interstate Commerce Commission is the possibility that enthusiasm or aggressiveness in the investor community could result in an LBO package that might not survive a downturn in business without deferral of maintenance and capital spending that are necessary for an efficient rail operation. Whether this concern is of sufficient magnitude to warrant new legislation is something about which there is not agreement within the ICC.

The commission's existing jurisdiction does not reach these transactions evenly or consistently. The commission has jurisdiction over the issuance of securities by rail carriers, but not by their parents.

The commission has jurisdiction over acquisitions that involve more than one railroad, and we have jurisdiction over the acquisition of lines of rail through asset sales. But stock purchases by outside investors are not now regulated.

Pages 9 through 17 of our prepared testimony outline some of the technical and substantive problems that the commission sees in the bills that we have analyzed to date. One difficult common to both bills is the absence of a clear signal to the commission as to the degree to which Congress intends to prohibit additional risk from debt financing. I would add that the House bill in particular seems to catch more in its web than would be necessary if the goal is a limited review of takeovers that resulted in excessive leverage.

For my part I am not convinced that there is a reason for expanded regulation of financial restructuring in the rail industry.

As an industry railroads do not carry a great deal of debt. Over the past 14 years the amount of debt as a percentage of rail capitalization has been reduced by half. In 1975 debt amounted to about 45 percent of total capital for the railroads. Today it is less than 24 percent. The table attached to our testimony shows the result of this trend—rail carriers have the lowest percentage of debt of all sectors surveyed. By comparison we estimate debt at about 40 percent of capitalization for transportation equipment manufacturers, 50 percent for textiles, about 50 percent for producers of stone, clay, glass, iron and steel.

The regulatory environment and the financial markets are more congenial to railroads today than in the early 1970s. Earnings are stronger and more stable. Carriers are developing new and expanded markets, and investors will understandably believe that more debt can be used advantageously because debt is typically cheaper than common equity capital. For 1988 we calculate the cost of rail debt is 9.7 percent. The cost of common equity is three points higher at 12.7 percent.

Those who favor using debt as a financing tool argue that debt frequently imposes more discipline on managers—that cost cutting and attention to profitability are heightened by the rigors of debt service and a capital structure condition which are frequently part of the senior debt instruments.

In the same vein, the threat of a leveraged buyout, or any other form of takeover, can also be an important motivator. Companies in the regulative sector—with extraregulatory barriers to free capital movements are frequently characterized as sluggish and resistant to change. Their sluggishness and their protected status are not coincidental.

We do not need another round of rail bankruptcies in the 1990s, so the concern over excess debt is understandable. I agree with it. But history needs to be read carefully. The bankruptcies of the past did not occur in an environment of too little, but too much regulation.

There was more than ample jurisdiction to consider the restructuring of the Penn and New York Central Railroads, and there was no lack of authority over the midwestern railroads.

Indeed, a host of uneconomic conditions imposed by the government contributed to the demise of the Penn Central and regulatory delay killed the Rock Island.

Unfortunately ICC review is no guarantee of ongoing successful operations.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

[The statement and questions and answers follow:]

STATEMENT OF HEATHER J. GRADISON, CHAIRMAN
INTERSTATE COMMERCE COMMISSION
BEFORE THE SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION, SUBCOMMITTEE ON SURFACE TRANSPORTATION
ON S.1005, LEGISLATION RELATING TO THE SALE, PURCHASE, OR OTHER ACQUISITION OF CERTAIN RAILROADS

June 22, 1989

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to present the views of the Interstate Commerce Commission concerning legislation relating to leveraged buyouts in the rail industry. Recent events have focused attention on the ramifications of these transactions. By way of background a review of a sample of such developments may be helpful.

Background

In May, the Commission instituted a proceeding to examine a proposed leveraged buyout of the Chicago and North Western Transportation Company (CNW) by the Japonica Partners. The transaction would have added approximately $650 million in new debt to CNW. On May 15 the Commission, in a letter to several members of the Commerce Committee, reviewed Japonica's proposal. The letter noted that the extent of the Commission's jurisdiction to evaluate the transaction was unclear. Although at least two Commissioners indicated in separate statements that they would have required Japonica to apply for authority to execute the buyout, there was no consensus as to the statutory basis for the Commission's exercise of jurisdiction. As to the specifics of Japonica's proposal, the Commission's letter concluded that it would be difficult to determine the likelihood that the post-acquisition process would proceed as projected. Japonica presented a plan for continued operations of the railroad after some initial asset sales. However, the Commission noted that Japonica's predictions of the effects of a recession on profitability were based on a best-case scenario, and the possibility of consequences more serious than those predicted by Japonica could not be dismissed.

Japonica's projections were never tested; it terminated its tender offer for CNW after CNW's directors approved a merger agreement with an investor group led by Blackstone Capital Partners. The Blackstone offer (consisting of $45.50 cash and $4.50 in preferred stock) includes the assumption of existing debt, and is valued at approximately $1.6 billion. New debt of up to $1 billion could be added to the CNW balance sheet. The Blackstone group would also provide new equity of $300 million, including $100 million cash from the Union Pacific Railroad for preferred stock. In exchange for the Union Pacific investment, CNW will commit to spend a total of $115 million through 1992 to maintain and upgrade CNW's east-west main line. Under existing law, the acquisition of CNW by Blackstone will be subject to Commission review due to the fact that Blackstone controls other rail carriers.

In a second buyout involving another of the smaller class I railroads, Rail Acquisition Inc., a wholly-owned subsidiary of the Prospect Group, Inc., in March acquired a controlling interest in the Illinois Central Railroad Company (ICR)'s holding company parent, the Illinois Central Transportation Company. Prospect now seeks to complete this acquisition and has made a cash offer for the remaining stock of Illinois Central Transportation. Unlike the initial acquisition of control, the second stage of this buyout requires Commission approval because of the issuance of new debt securities guaranteed by the railroad. The Commission in May instituted an investigation into the effect on ICR of the refinancing transactions proposed in connection with the acquisition. The Commission relied on 49 U.S.C. 11301, requiring prior approval for issuances of securities by railroads, in staying a class exemption which would otherwise have applied to the securities issuance.

For a third example, we would point to an internal restructuring which is similar in effect to a leveraged buyout. In late April, Union Pacific Corporation announced a restructuring plan to buy back as much as 13 percent (14.5 million shares) of its outstanding common stock. Based on the late April share price of $71, the repurchase of the 14.5 million shares would have cost approximately $1 billion. In fact, 11 million shares were tendered at a reported cost of $800 million. In terms of balance sheet impact on the corporation, the buy-back increases long-term debt by approximately the amount needed to fund the repurchase. This decreases stockholders' equity by the same amount. The private placement of credit instruments used to raise the buy-back capital is not subject to Commission review. The actions taken by Union Pacific have the same conceptual impact as a leveraged buyout. The extent to which Union Pacific acted to forestall a takeover attempt is unknown, but the decision to sell its real estate operations (also announced in April) is consistent with a defensive strategy.

There are a number of reasons for the recent frequency with which railroads have been the subject of buyouts or restructurings, which lead to creation of substantial additional debt. As an attachment to this testimony we have included a table showing the capital structure ratios for selected industries. (The capital structure ratio is defined as the percentage of debt to total capitalization.) The table shows that Class I railroads have the lowest percentage of debt of any of the sectors examined. Given the increasingly stable and positive earnings experience of the industry after partial deregulation, investors may conclude, perhaps with good reason, that at least some railroads can safely carry significantly higher debt loads. Since the ability to leverage the target company after takeover is an important element in raising short-term commitments for take-over capital, the rail industry -- with its low debt and improved earnings -- is a natural target. Adding to this attractiveness is the fact that many railroads hold real estate assets (typically with book values well below market) that may be sold to reduce new debt in the short term.

There is thus a wider margin in the rail industry than in others for the addition of debt. The reasons for the conservative structure of the industry's balance sheets are several, including recent favorable tax treatment and the capital-intensive nature of the industry (which permits generous depreciation-based cash flow). Adding to the attractiveness of many balance sheets is the fact that much of the difficult restructuring that was foreseen in the 1970's has been accomplished. The post-deregulation railroad industry has passed through a major rationalization affecting asset size, labor costs, marketing relationships, and technological development. The process has not concluded; there are more difficult and perhaps painful tasks to be finished, but much has been accomplished. Many of the companies within the industry are now able to see potentially stable and profitable operations, and the flexibility provided by deregulation has ensured that railroads have much of the ability enjoyed by other industries to tailor their operations to fit prevailing economic conditions. This has increased investor acceptance of the railroad as an area for new capital.

Legislative Issues

There is widespread debate over the emergence of the leveraged buyout as a takeover instrument and financing tool in the economy generally. The Commission professes no special expertise in this area. We would note only that there are arguments on both sides. Some observations are, however, possible. First, the appearance of additional debt on the balance sheet should not by itself be considered a problem. While there may be circumstances in which too much debt is acquired, many of the Class I carriers have very low debt profiles. Because debt is cheaper than other forms of new capital, discouraging its acquisition, at reasonable levels, may not be sound transportation policy.[1] Second, the possibility of the leveraged buyout by outside interests carries with it the disciplinary effect of a threat to incumbent managers. There is little question that secure incumbency can produce excessive cost and slow innovation. Consequently, the issue becomes one of balancing the positive influences that arise from low-cost financing and competitive markets for corporate control against the possibility that exorbitant debt (perhaps the result of excessive enthusiasm or aggressiveness in the acquisition community) will lead to a structural weakening of the rail sector.

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[1] Since the revenue adequacy test used by the Commission determines a cost of capital based on the relative mix and costs of debt and equity, increasing the relative percentage of debt financing within the sample group will typically reduce the target rate of return at which a carrier is considered revenue adequate.

The public attention to these questions is heightened in the rail industry because, more so perhaps than in other fields, railroads can have a profound impact on community development and commercial enterprise. An efficient rail plant is something from which complementary productive activity can benefit. Frequently rail transport is the only economical means of transporting heavy freight. Loss of high quality rail service is a serious blow to regional and community commercial development. As we noted in our letter regarding the Japonica acquisition, loss of service on operable properties (usually preceded by periods of deterioration) has often led to the expenditures of public monies for rehabilitation and return to rail usage. The premier example is, of course, the several billions spent in the rehabilitation of Conrail. Consequently the public has an interest in the success or failure of rail carrier acquisitions that may exceed that found in the typical industry setting.

Related to this is the fact that the railroads have been able to recover cash and reduce debt, to some extent, as the intentional result of a variety of government programs, from deregulation to tax policy to subsidy. The strengthened positions of these carriers were presumably intended primarily to benefit transportation interests, rather than investors or arbitrage specialists. Hence, public and congressional concern has focused on the fact that in many cases, leveraged buyouts of large rail carriers can take place without government scrutiny. This is so despite the fact that transactions of much smaller scope, such as the merger of two small railroads or the acquisition of a segment of line are subject to Commission review.[2]

Under current law, the Commission has jurisdiction to authorize the unification of control of two or more rail carriers, either directly or indirectly (49 U.S.C. 11343), and to approve the issuance of securities by a rail carrier (49 U.S.C. 11301). If a leveraged buyout of a railroad is structured in a manner that would not trigger jurisdiction under either of these sections, government review of the transaction (other than that exercised by the Securities and Exchange Commission) would be unlikely. Several legislative proposals have been introduced to give the Commission authority to review leveraged buyouts not now subject to the Commission's jurisdiction. The most significant of these are discussed below.

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[2] 49 U.S.C. 10901 would require Commission approval of the sale of a line if the acquisition were of the assets rather than the stock of an existing road.

S. 1005

S. 1005 was introduced on May 16 by Senators Harkin, Pressler, Simon, Grassley and Daschle. According to the introductory statements, this legislation is designed to give the Commission unambiguous authority to regulate leveraged buyouts. The bill adds a new provision to Section 11343 of the Interstate Commerce Act (the Act), requiring Commission approval of any acquisition of control of a Class I railroad carrier by a non-carrier, the result of which may produce a significant diminution or deterioration of service to be provided by the carrier, or which may increase the debt of the acquired carrier and adversely affect the ability of the carrier to provide an adequate level of service consistent with the public interest.

The bill would accomplish the basic objective cited by its sponsors, i.e., it would require the Commission to examine any proposed leveraged buyout of the largest ("Class I") railroads. However, S. 1005 would not give the Commission meaningful direction to determine which buyouts are acceptable. The standard under which the Commission would review the transaction is found in Section 11344: In a proceeding which does not involve the merger or control of at least two Class I railroads, the Commission shall approve an application unless it finds that (1) as a result of the transaction, there is likely to be substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States; and (2) the anticompetitive effects of the transaction outweigh the public interest in meeting significant transportation needs. The standard recited above compels an analysis of competition. However, application of S. 1005 is limited to cases in which a Class I railroad is being acquired by a non-carrier. In these cases, the impact on competition would probably be negligible (unless the buyout plan called for large-scale abandonments, or significant line sales to competitors -- and these transactions are already subject to Commission review). In most leveraged buyouts decided under S. 1005, the Commission would have no choice other than to approve the transaction.

Furthermore, the Commission would not be called on to evaluate criteria mentioned in the bill itself (significant diminution or deterioration of service, increase in debt, or impaired ability of the carrier to provide an adequate level of service consistent with the public interest) because these criteria are used only as descriptive phrases. If S. 1005 is intended to compel the Commission to take these factors into account, the criteria should be set forth as standards for the Commission's approval of the transaction.

In addition, the wording of S. 1005 appears to give the participants in the transaction substantial discretion to determine whether Commission review is required at all. For example, the bill would apply to acquisitions which may produce a significant diminution or deterioration of service to be provided by the carrier. Based on this language, a proponent of a leveraged buyout could take the position that the transaction need not be submitted to the Commission for approval because the diminution of service would not be substantial. While we expect that the Commission could challenge this conclusion in court, the current formulation of the bill invites litigation. If S. 1005 is intended to give the Commission clear authority to evaluate leveraged buyouts, the statutory language should more clearly delineate those transactions requiring Commission review.

Because S. 1005 amends Section 11343 of the Act, labor protection is mandatory. Section 11347 of the Act directs the Commission to provide a fair arrangement at least as protective of the interest of employees who are affected by the transaction as the terms imposed under Section 11347 before February 5, 1976, and the terms established under section 405 of the Rail Passenger Service Act (45 U.S.C. 565). Under section (2) of S. 1005, any purchase, sale or transfer of a Class I railroad is deemed to be a purchase, sale, or transfer by a carrier providing transportation subject to the jurisdiction of Commission under subchapter I of chapter 105 of title 49 of the United States Code. Under Commission precedent, the level of labor protection required in a purchase, sale or transfer of one rail carrier by another is set forth in New York Dock Ry.-- Control, 360 I.C.C. 60 (1979), aff'd sub nom. New York Dock Ry. v. United States, 609 F.2d 83 (2d Cir. 1979). The labor protective conditions required by New York Dock include displacement allowances, dismissal allowances, reimbursement for moving expenses, and other benefits. In addition, if the New York Dock conditions were to be applied, a buyout could not take place without prior negotiation of an implementing agreement between the acquiring entity and the employees of the acquired entity.

Further, it may be quite difficult to determine whether adverse effects claimed by employees come within the terms of the protective conditions imposed. In other situations in which labor protection is mandatory, such as acquisitions or abandonments, the Commission can ordinarily identify how a transaction affects employees. However, if a railroad undergoes any changes in operations after a leveraged buyout (regardless of whether the changes were contemplated at the time of the buyout), arguments will be made that the changes are the result of the buyout, and thus should trigger labor protection. To the extent that these arguments are successful, a railroad that undergoes a leveraged buyout could face unanticipated labor costs which would not be borne by competitors.

In addition, if the acquired carrier sells lines to non-carriers, these sales would be subject to labor protection. In similar situations involving carriers not subject to leveraged buyouts, Congress has not imposed similar requirements. Labor protection is not required in connection with sales of lines subject to abandonment under section 10905, and the Commission is given discretion to determine whether labor protection should be required for sales of lines to non-carriers under section 10901.

Other, more technical considerations, also deserve mention. The reference to acquisitions of control of Class I railroads could also subject the formation of railroad-controlled holding companies to Commission review. This result may not be intended; these transactions do not now require Commission approval.[3]

In addition, the bill applies to all non-carrier acquisitions without reservation. It therefore requires Commission approval of acquisitions by non-carriers affiliated with carriers, who would be required to file under other provisions of section 11343. We recommend the bill be clarified to eliminate this overlap.

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[3] Creation of a holding company could involve Commission jurisdiction under section 11301 (if securities are issued), or possibly section 11343 (consolidation, merger, and acquisition of control) if more than one carrier were involved. However, creation of a holding company, to control a single railroad or a group of railroads operated as a single system does not now require Commission approval.

S. 1005 is silent as to Commission procedure. The Act at section 11345 establishes procedures to govern applications under section 11343. Absent any indication in the bill or legislative history to the contrary, those procedures would apply to this legislation. Section 11345 provides two possible sets of time frames and procedures depending on whether the transaction is "of regional or national significance." Under the Commission's existing regulations, the determination of regional or national significance turns on whether or not the transaction will result in a major market extension. If it does, the transaction is considered "significant", and section 11345(c) governs. If not, the transaction is considered "minor" and the expedited (180 day) procedures set forth in section 11345(d) apply. However, because the concept of "major market extension" is essentially one of competitive impact, and is irrelevant to a non-carrier acquisition, it is unclear what time frame is intended.

In addition, subsection (3) of the bill sets an effective date of May 16, 1989. The legislation provides no mechanism for implementing this provision. Should a situation arise in which retroactive exercise of jurisdiction under S. 1005 is required, the Commission would have no guidance (and may not have the authority) to resolve the practical problems arising from retroactive application of S.1005.

H.R. 2364

On June 6 the House Committee on Energy and Commerce reported H.R. 2364, a bill to authorize appropriations for Amtrak. The Amtrak bill includes a provision (derived from H.R. 2513) that would give the Commission jurisdiction over an acquisition of control of a Class I rail carrier by a person that is not a carrier. H.R. 2364 amends section 11348 of the Act to require the Commission to consider the effect of the transaction on the adequacy of transportation, resulting fixed charges, and the interest of carrier employees. Although H.R. 2364 lists criteria for the Commission to consider in deciding whether to approve a leveraged buyout, it does not indicate how the Commission is to weigh these various factors in reaching its decision. Unlike S. 1005, H.R. 2364 would not subject the creation of a railroad holding company (established by the carrier itself) to Commission review.

When the transaction contemplates a guarantee or assumption of payment of dividends or fixed charges or will result in an increase of total fixed charges, section (4) permits the Commission to approve the transaction only if the guarantee, assumption or increase is consistent with the public interest. However, the Commission is given no guidance as to how much of an increase in dividends or fixed charges would be consistent with the public interest. This point is significant because the grant of authority in section (4) is unique, and does not exist with respect to other rail transactions decided under section 11344(d). In addition, the legislation could apply not only to carrier guarantees, assumptions, or increases, but also to those of holding companies exercising control over railroads. It may be worthwhile to distinguish those transactions in which the financial health of a Class I rail carrier is potentially affected from those in which it is not, and to require Commission review only of the former.

We also note that H.R. 2364 would require prior Commission approval for the creation of voting trusts in future consolidation cases, since the trustee would appear subject to the provisions of the bill. This result is a departure from existing law, and probably is not intended, since in most cases the trustee of a voting trust is a bank, not affiliated with a carrier, and control is exercised only in a ministerial sense.

While H.R. 2364 does not require labor protection in every leveraged buyout, it does direct the Commission to consider the effect of a transaction on employees. As we read H.R. 2364, Section (4) permits the Commission to impose labor protective conditions on a case-by-case basis. The Commission would have discretion to tailor the nature of the conditions to the particulars of the transaction.

As a technical matter, the time limits in H.R. 2364 present problems. Proposed subsection (a)(5) provides only 10 days for the Commission to examine an application and arrange for its publication in the Federal Register. This gives the Commission a maximum of 5 calendar days for its examination, because the Federal Register requires a minimum of 5 working days to publish on a specified date. At least 15 days for acceptance and publication in the Federal Register should be provided. Overall, the bill provides 90 days from filing to final decision. This is only half the time now allotted by section 11345(d) for the processing of minor transactions, and may not give the Commission time to perform a meaningful analysis, particularly if opponents to the transaction question the validity of underlying financial information submitted by applicants. In addition, the Commission is given only 10 days after enactment to issue interim regulations implementing H.R. 2364. The agency should be afforded more time to issue these regulations, and the legislation should specifically provide that the interim rules can take effect without notice and comment, notwithstanding the requirements of the Administrative Procedure Act.

Finally, the effective date (June 1, 1989) presents the same practical problems for retroactive implementation as does S. 1005.

Conclusion

Several points should have emerged from the foregoing. That there is widespread debate over whether the leveraged buyout phenomenon represents a positive development for American industry is without question. That there is the possibility, or more precisely emerging reality, of an active market for leveraged buyouts or related internal restructuring within the railroad community is also without much doubt. While the Commission does not profess expertise over the issue of leveraged buyouts generally, we have indicated why there is the probability of restructuring within the rail sector. It is also clear that the Commission's jurisdiction over these transactions is ambiguous, disputed, and incomplete. We have also described some of the technical and not so technical difficulties with two of the bills that have been offered to amend those jurisdictional problems.

The Commission is divided, however, as to whether new jurisdiction is advisable and that division reflects the split surrounding the issue of leveraged buyouts generally. Those who would support new jurisdiction do so out of a belief that rail operations are central to commercial and community development and that they should not be threatened by speculative debt. Those that are reluctant to see new regulatory hurdles feel that the capital markets are themselves most able to detect inefficiencies and the opportunity for more competitive service, and that, over and apart from the natural incentives of the investors, the public already has the special protection it needs in the various provisions of the Interstate Commerce Act that require careful attention to abandonments and permit the acquisition of under-utilized assets by communities and commercial users.

If the Committee should conclude that it wishes to pursue legislative amendment, the Commission is anxious to work with the Committee to design legislation that would fulfill the Committee's intent. New law that might be all encompassing jurisdictionally but only ambiguously defined as to intent would be the most difficult and costly to administer, both in terms of cost to the transport sector and to the validity of the administrative process. Careful cooperation beforehand will aid the Commission in its new charge and help reduce the possibility of confusion and controversy in application.

Attachment: Selected Capital Structure Ratio Data

SEPARATE STATEMENT of Vice Chairman Simmons:

I favor legislative proposals to give the Commission jurisdiction over acquisitions of control of Class I railroads by persons that are noncarriers. Given heightened public concerns over recent attempts by noncarriers to acquire major railroads, I believe legislation is necessary to resolve the jurisdictional issue once and for all. Furthermore, I believe jurisdiction in this situation is necessary in order to promote the public's interest's in maintaining a financially sound railroad system.

Let me stress that I do not oppose transactions of this type. There will be acquisitions by leverage buyouts which could be beneficial to a railroad and its customers by infusing new management and ideas to improve the quality of service. However, such acquisitions must be balanced with the public's need for a financially sound railroad system. Despite concerns that new legislation could place hurdles on the capital market forces, I do not believe legislation would seriously hinder the marketplace or deter those investors who wish to invest in the industry.

While it is Congress' prerogative to fashion whatever bill is eventually adopted, I, nevertheless, believe any legislation must contain clear standards and guidelines in order for the Commission to conduct any meaningful review. For instance, I support provisions which permit the ICC to review the financing of a transaction. This analysis would allow the Commission to determine if a substantial increase in debt because of the transaction could erode a carrier's financial health to the detriment of the public that carrier serves. Likewise, I support a timetable which allows for comments and a reasonable period for ICC review while not unduly delaying such transactions.

SEPARATE STATEMENT of Commissioner Lamboley:

While I subscribe to most of my colleagues' views, my concern for the broad issues involved in transactions which have prompted legislative review both in the Senate and in the House stems not from a particular regulatory philosophy, but from the perspective of public interest concerns over the impact of leveraged transactions on rail transportation systems and operations. The suggestion that *new* legislation favored by some is regulatory in contrast with capital market based initiatives and restraints favored by others, is misplaced.

From testimony in the Commission investigation of the CNW/Japonica transactional proposals we learned first-hand that the finance and capital market considerations, and that of the management and stockholders, in takeover situations was much more narrow, and indeed did not reach the broad public interest factors considered under the ICA.[4] For the acquired, the finance evaluations are basically the adequacy of the price being paid and the wherewithal of the acquirer to pay at closing.[5] After closing, the consequential impact of the transaction on the enterprise and its assets for the acquirer is focused on the financial ability to pay the indebtedness created by the leveraged transaction, and not necessarily on the longterm viability of the system and its operations to provide and profitably maintain continuing rail transportation for the markets served. It is the latter which is the Commission's public interest assessment, a task which it has historically performed, and for which it has had continued responsibility.

For me then, the pending Congressional action does not anticipate creation of new jurisdiction in the Commission, but quite properly clarification of existing jurisdiction, made necessary for those who seemingly doubt Commission jurisdiction and responsibility.[6] I continue to adhere to the view that the central question is not whether the Commission has jurisdiction but rather how it chooses to exercise that jurisdiction.

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[4] See Transcript of Proceedings, May 9, 1989 in Ex Parte No. 480 CNW Transportation Ramifications of Acquisition by Japonica Partners, Letter Report to Senators (not printed) served May 15, 1989.

[5] Witn. Schmiege, Transcript, supra, pp. 55-56.

[6] As can be gleaned from review of Commission cases involving rail acquisition and securities, a majority of the Commission takes a more narrow view of jurisdiction. Of course, division among the Commission regarding jurisdiction over corporate structure and related issues is nothing new. In 1977, the Commission was divided as to the scope of its investigatory jurisdiction and

Current legislative proposals, in my view, do not clearly reach beyond the outsider "hostile takeover" situation. Leveraging concerns may arise in the context of either friendly or hostile takeovers, and any potentially include either insiders and/or outsiders. "White Knight" or "management led" takeovers frequently present similar leveraged debt issues. In more limited fashion, ESOP transactions may also present debt considerations. Additionally, corporate restructuring may present significant debt/equity issues.[7]

Finally, consideration of labor protection issues should recognize the inherent distinctions between the leveraged transactions here contemplated, which may lead to the takeover or acquisition of an entire railroad, and those transactions under §§ 10901, 10905 or 10910, or those carrier-carrier transactions under § 11343, as well as the benefits, burdens and obligations of the respective parties involved in the transactions.

Review of varied transactional activities should, and no doubt will, be included within the scope of legislative review,

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responsibility relative to holding companies. See Railroad Conglomerates and Other Corporate Structures, a Report to Congress as Directed by §903 of the Railroad Revitalization and Regulatory Reform Act of 1976, Interstate Commerce Commission, February 5, 1977.

[7] Coincidentally, a fourth example could have been discussed, that being the recent BN restructuring which located substantial debt in the railroad subsidiary after assets were restructured.

and any action taken will hopefully clarify any ambiguity over the jurisdictional purpose and reach of legislation adopted. I support clarification of the Commission's authority and appropriate role.

ATTACHMENT

Selected Capital Structure Ratio Data
By Industry Group
Ranked in Descending Order
1988

Industry	Long-Term Debt	Equity	Total Capital	CSR
Retail Food	25,167	9,467	34,634	72.67%
Iron & Steel	10,890	5,377	16,267	66.95%
Stone, Clay, & Glass	17,033	12,864	29,897	56.97%
Other Nondurable Mfg.	6,150	4,662	10,812	56.88%
Textile Mill Products	10,058	9,711	19,769	50.88%
Other Retail	34,061	34,875	68,936	49.41%
Retail General Merchandising	39,566	42,276	81,842	48.34%
Primary Metals	20,926	23,523	44,449	47.08%
Food	86,352	97,460	183,812	46.98%
Mining	22,577	28,462	51,039	44.23%
Rubber & Misc. Plastics	9,128	11,633	20,761	43.97%
Fabricated Metal Products	17,793	24,452	42,245	42.12%
Printing & Publishing	27,106	39,790	66,896	40.52%
Paper Products	25,492	39,819	65,311	39.03%
Other Durable Mfg Ind	10,697	16,775	27,472	38.94%
Nondurable Wholesale	21,522	37,281	58,803	36.60%
Industrial Chemicals	27,675	49,336	77,011	35.94%
Nonferrous Metals	10,037	18,147	28,184	35.61%
Instruments	19,967	38,938	58,905	33.90%
Chemicals	55,915	111,750	167,665	33.35%
Petroleum & Coal	70,216	140,336	210,552	33.35%
Transportation Equipment	44,240	109,535	153,775	28.77%
Motor Vehicles & Equipment	28,602	73,593	102,195	27.99%
Durable Wholesale	15,466	42,330	57,796	26.76%
Aircraft & Missles	12,348	33,957	46,305	26.67%
Electric & Electronics	30,968	87,489	118,457	26.14%
Machinery Except Electrical	36,825	105,067	141,892	25.95%
Drugs	7,901	25,104	33,005	23.94%
RAILROADS	8,285	26,467	34,752	23.84%

NOTES

Railroad data are from ICC sources.

Data for non-rail companies are from the Bureau of the Census' "Quarterly Financial Report" for the Fourth Quarter of 1988.

Manufacturing firms are those with assets over $25 million.
Wholesale and retail firms are those with assets over $50 million.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS THERETO

1. Chairman Gradison, you testified before the Committee that you have no objection to the ICC "interviewing suitors...to understand their intentions", as in the case of the attempted Japonica takeover of the Chicago and Northwestern. However, under current law there seems to be considerable doubt as to whether or not the ICC would have authority to act even in cases where these "interviews" might yield information leading the ICC to doubt the viability of the proposed transaction. Please elaborate on your support for "interviews" in contrast with your reservations about the enactment of legislation.

The experience with the Japonica proposal for acquisition of the Chicago and North Western demonstrates several points. First, the Commission has the jurisdiction and the authority to require submission of information necessary for an initial appraisal of the quality and character of any proposed leveraged buyout. Second, a short appraisal period is all that is needed for the Commission to determine whether the proposed transaction is premised realistically on continued operation of the railroad. Third, and finally, it also became clear during our review that elaborate financial analysis and economic forecasting would be necessary to match the background work that will have typically been done by the would-be buyers for presentation to lenders and equity investors. Doing so would have required significant time and money.

The procedure we followed in the Japonica "interview" could easily have identified a transaction in which a break-up and sell scenario was anticipated. In such a case the Commission already has the authority to exercise considerable control over the possibility that a deal could move forward. No one contemplating a restructuring that involves line sales or abandonments can expect to proceed profitably without the concurrence or acquiescence of the Commission. Hence, a Commission pronouncement that it did not favor the break-up of a carrier's assets would be, in all likelihood, sufficient to dry up the transactional investment monies that are needed to proceed. In any event, line sales and abandonments are fully regulated and cannot take place without ICC approval.

The enactment of new legislation will, I fear, involve the Commission in attempts at second-guessing operational plans for existing lines where improved service, not its elimination, is the goal. The benefits from such a review are likely to be problematical, while the potential for imposing unwarranted costs and reducing the efficiency-enhancing threat of restructuring by outsiders is real.

2. If LBOs result in increased burdens and if some railroads prove unable to meet these burdens, do you feel that the taxpayers might have to again pick up the shortfall and preserve service, much as the taxpayers had to do in the 1970's with the creation of Conrail?

While there is some precedent for rail bailouts, it is unlikely that it will be necessary for this path to be followed again. Past failures have been largely attributable to past excessive regulation. Because of the government's involvement in the causes of failure, assistance in rehabilitation had an aspect of symmetry and fairness. In the post-Staggers era, the performance of the railroads is far more closely tied to their own skill and endeavors. They have been doing much better, and as a result there is an active market for their control.

3. Last year, Burlington Northern spun off its natural resources company from its railroad. The natural resources company was spun off relatively debt-free and the railroad assumed an additional debt of $2.5 billion previously incurred by its natural resources company. Earlier this year, Union Pacific repurchased 11 million of its own shares, increasing its long-term debt by as much as $800 million. Do you have any views as to the potential impact of this on railroad operations, particularly in an economic downturn? Should the ICC play a role in cases such as this?

Neither of the two internal restructurings poses any immediate and no apparent long-term threat to either of the two railroads. These are both well-structured and well-positioned companies with solid traffic and efficient operations. In both cases, there is reason to suspect that the restructurings were undertaken, at least in part, to forestall the possibility of more aggressive outside attempts at maximizing short-term shareholder values. The Commission cannot and should not attempt to second guess such transactions.

Senator EXON. Thank you very much, Madam Chairman, and let me for the record indicate that the full statement will be accepted as a part of the record.

And to save time for the future panels, statements by Mr. Kennedy, Mr. Rensink, Mr. Swartz, Mr. Voytko and Mr. Runde all are accepted in full as part of the record when they are presented to the committee today.

Let me ask you a few questions. First, Madam Chairman, I understood that you generally favored some type of legislation in this area, but in listening to your comments I was not sure. Can you answer this question: In your opinion, as the Chairman of the ICC, should Congress pass legislation in this area to clarify and give the ICC more jurisdiction or authority than it has now or should it not?

Ms. GRADISON. In my opinion as Chairman of the ICC, the Congress should not pass legislation to change the commission's jurisdiction.

We have thorough and adequate tools with which to reach these transactions at some point, and to inject the Interstate Commerce Commission at this time simply adds questions for the market and adds delay and reduces the industry's ability to function in the financial community.

Senator EXON. Then what you are saying is that if the proposed buyout, leveraged buyout or call it what you will, if the unfriendly takeover of the Chicago Northwestern had come to pass, you do not think that the ICC had the jurisdiction to even take a look at that and you do not believe in the future that that presents a serious enough problem that the ICC should take a look at it? Is that a fair statement?

Ms. GRADISON. I would like to add a qualifier to that if I may.

Senator Exon. I am trying to find out where you are coming from.

Ms. Gradison. I have no objection to the commission interviewing as we did in the Japonica attempted takeover, that is, interviewing Japonica to understand their intentions, or interviewing suitors. But for the commission to have the jurisdiction that these proposals would give us, at what point would the commission have a role in the transaction? If we had begun one of these types of reviews for Japonica and the negotiations within the market continued, the commission still would have had an ongoing Japonica review while the Blackstone group worked on their agreement.

At what point does the commission's role kick in? At what point does the commission's role kick out? And it is important for the committee to know that those securities that are ultimately issued in order to cover the debt do come under the commission's jurisdiction if the rail carrier is responsible for the debt. So, ultimately, the transaction does come before us.

Senator Harkin was concerned about a potential delay, but the delay that he spelled out was a potential delay in the event of an abandonment. That is a long way down the road.

It is not in an investor's interest to kill the cow that produces the cash. The railroads have to have a viable ongoing productive and competitive operation in order to produce the funds to service the debt.

It is not in an investor's interest to so highly leverage a carrier that he cannot service the debt. The investor needs the ongoing operations of the railroad to service the debt, and I do not believe we will see inordinate increases in debt. We may see a doubling or a tripling of an existing carrier's debt, but with the rail industry's historic low level of debt, that may not be a bad thing.

Other problems with the legislation are that an existing carrier could not financially restructure itself. What if that financial restructuring is to invest in its own capital assets? What if that financial restructuring is to pay for a new rail line or a new rail yard or for computerization of their operations?

These industries must have the flexibility to run their operations in a viable manner. I share your concern that I do not want to see this industry stripped. I do not want to see the industry put back where it was before the Staggers Act, but I do not believe that either one of these pieces of legislation will serve the purpose of addressing the concern that you and I share.

Senator Exon. If you and I could agree on a piece of legislation that would address—and I quote you—"the concerns that you and I share," would you be for it?

Ms. Gradison. You bet.

Senator Exon. Would you be good enough to supply for the record, Madam Chairman, or have you in your statement the changes that you feel would be necessary to meet that worthy goal?

Ms. Gradison. No, sir. The limited role that I see necessary for the Interstate Commerce Commission to play is that of a gatekeeper with a clear definition of what our roles and responsibilities are. Our statement does not address specifically a piece of legislation that would do that, and I would be hard-pressed to come up with one.

We are willing to work with you to help address these mutual concerns on a staff-to-staff basis and help design something that would be suitable.

Senator **Exon**. Let me give you an iffy question. Supposing someone would come along today and decide that they were going to force a leveraged buyout of the Union Pacific Railroad for the purpose not of continuing to operate it over the long term as a railroad, but they were particularly interested in the ownership that the Union Pacific Railroad has in certain pieces of property not directly connected with operating a railroad in certain parts of the United States and they were really looking to make a killing out of that and then abandon the Union Pacific as an operating railroad.

Now, that is an iffy question of how much are they going to pay for it and all that. But if you and I could agree long enough to say that that was obviously the intent of the road or the purchase of the road, would you say that even under those kinds of circumstances you do not believe that the ICC should have any authority to step in and protect the basic rail service of America?

Ms. **Gradison**. We already have that authority. The existing statutes give us that authority. If that purchaser were to issue substantial amounts of debt, those issuances would come under scrutiny of the Interstate Commerce Commission today. Under our review no new legislation would be necessary for us to look at that.

In fact, we are required to.

Senator **Exon**. Is it true that you have that authority even though a non-railroad would try and buy Union Pacific for the intent that I outlined in my let us suppose question?

Ms. **Gradison**. Only if the debt was issued by the railroad. If the non-railroad issued the debt, it would not come under our jurisdiction. But, again, this goes back to the point I tried to make earlier which is that it is not in a new purchaser's interest to kill the cow that produces the cash.

Even if they were to have an interest in the real estate and not the rail operations and they were to attempt to then sell the railroad, the commission would then have to take a look at who—we would possibly take a look at who the operator of the rail operations would be. If someone were to try to abandon the rail lines again, abandonments are fully within our jurisdiction, and we would have to look at that.

In the instance of the Union Pacific where we have viable ongoing rail transportation services in effect today, it would take a long period of time before those lines were eligible for abandonment, and if that leveraged buyout were such as you described, those investors would not have the amount of time to run the business into the ground.

We have the authority to work with, we are willing to use that authority when necessary. Specifically we did talk with the Japonica partners when they anticipated a purchase of the CNW.

I would imagine that the commission in the future might ask what its composition is, and might be interested in those types of transactions. But it would be extremely cumbersome for us to get involved in every attempted purchase until the cycle, the market cycle plays itself out.

Senator EXON. Of course it could be too late under that scenario, could it not?

Ms. GRADISON. I do not believe so, because ultimately the purchaser of the line would in some way, shape or form come within our very broad reach.

Senator EXON. That is the end of my questioning in the first round. My time is up.

I am glad to recognize the ranking member of the committee for any opening statement that he has and to continue with the questioning of the witness.

OPENING STATEMENT BY SENATOR KASTEN

Senator KASTEN. What we are considering here, Mr. Chairman, is one piece of a complex puzzle. In recent years we have seen a wave of takeovers, corporate restructurings and the leveraged buyouts throughout the U.S. economy. There has been a general increase in the debt burdens of U.S. companies. Many of these developments have increased efficiencies and have been beneficial to the economic structure of the country, and there have also been some economic dislocations which have caused problems for employees, local communities and other interests.

The railroad industry has not been exempt from the forces that are present in the rest of the economy as evidenced by the recent failed hostile takeover of Japonica Partners for the CNW. It is important that our subcommittee carefully consider the impact of takeovers and the increased leveraging on the railroad industry because these roads are vital lifelines in our economy. Our review of S. 1005 becomes all the more important given the passage of similar legislation by the House without any real hearings on the matter as an amendment to their Amtrak reauthorization bill.

We must consider whether the increased debt burdens might affect the ability of railroads to maintain service to communities that depend on them.

However, the railroad industry is a capital intensive industry. Many of us are concerned about capital formation in our economy and the cost of capital to our businesses. In that regard I am the sponsor of legislation to reinstitute the capital gains differential, and I oppose the double taxation of dividends. I am concerned that S. 1005 may adversely effect the ability of railroads to attract capital at the lowest rates possible. I also believe that the labor protection provisions of the legislation is ill-advised.

The deregulation of the railroads has generally brought about a rebirth of the rail industry, and we should tread carefully lest we foster, perhaps inadvertantly, any sort of return to the system that we had before deregulation which contributed to the demise of many of the roads, including the Penn Central.

Recognizing that not all takeovers are good nor are all bad, the Congress is proceeding cautiously in this area with regard to the economy as a whole and I believe we must do so here as well. I recognize the public's interest regarding rail service, but question the advisability of looking at takeover and LBO issues in a patchwork, industry-specific manner.

Today's hearing and our discussion of Senator Harkin's bill will help to put this issue in focus. I look forward to the testimony of our witnesses today. Mr. Chairman, I thank you for holding this hearing and we should all carefully consider the arguments presented by both the proponents of the legislation, and those of the ICC and others who oppose this bill.

I just want to make sure I understand. You are saying one way or another, the issues having to do with service, abandonment, maintaining levels of services to various communities, are already covered right now.

Ms. GRADISON. that is correct.

Senator KASTEN. And the question really is at what point they would have to come to you.

Now, maybe someone could have a plan to do something to a railroad, and maybe they could buy that railroad based upon that plan. But then if they had to start abandoning lines, for example, they would have bought something that they would be unable to get through the ICC. Is that not essentially what you are saying?

Ms. GRADISON. Yes, exactly.

Senator KASTEN. That at one point along the way the public is now protected. The public is now protected under all these different circumstances. It just depends upon at which point along the way the ICC would get involved.

The legislation puts the ICC in at the front at the very beginning and you then in effect become a financial analyst as well as a railroad regulator.

Ms. GRADISON. That is correct.

Senator KASTEN. And it seems to me as long as you maintain your work and expertise as a railroad regulator and a representative of the public interest with regard to rates and service and lines maintained or whatever that there is no reason for you to get into the financial analysis business at the same time.

Ms. GRADISON. That is correct. In fact, we may ultimately hinder carriers' long-term financial viability by being involved in the first step.

Senator KASTEN. One of the issues we have debated back and forth with regard to the ICC is the funding for the ICC and in the Transportation Appropriations Committee. And, as you know, I serve on that committee and we have worked together in that committee as well.

One of the issues has been funding. If we were to pass legislation similar to the legislation that is before us today, it would seem to me that you would have to go out and find a whole new group of people who would then become the experts on some of these financial efforts. Is that true? Or if this legislation passed, would you be able to just kind of take on these responsibilities without increased funding?

Ms. GRADISON. We would certainly have to broaden our expertise.

Senator KASTEN. And theoretically hire more people?

Ms. GRADISON. Either that or cross-train some of the regulatory people that we currently have, RIF in some areas and do new hires in others.

Senator KASTEN. Mr. Chairman, I have no further questions.

Senator EXON. Thank you very much, Senator Kasten.

Senator Pressler has joined us, a very important member of our committee and cosponsor of the Harkin bill, and I am pleased to recognize the Senator from South Dakota at this time for any opening statement and questions that he has of the witness.

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. Mr. Chairman, I shall be fairly brief because I know some of these subjects have been covered.

I shall place my opening statement in the record, but would like to summarize.

I welcome our witnesses and I want to thank you, Mr. Chairman, for your cooperation in scheduling this hearing in a timely fashion. Just as South Dakota, your state of Nebraska and Wisconsin and much of the other upper Midwest felt the threat of the hostile takeover of the Chicago and Northwestern Railroad.

Last month I appeared before the ICC. I described the people of the Midwest as like a nest of young chicks who could see the foxes circling. At that time the Japonica Partners were eyeing the Chicago and Northwestern. A number of investors were after Northwest Airlines as well. All we could do was to sit back and watch while our transportation future was being decided by Wall Street investors.

I am one of those who believes that we should have public policy reviews when issues with such clear public interest implications such as this arise.

The Blackstone Partners came to the rescue of the CNW management and another group outbid a number of other concerns for control of Northwest Airlines, but that is not the end of this story. There is a bigger question left unanswered. Who will be on guard to protect the public interest in the event of a hostile takeover of a railroad.

I believe the legislation we are discussing today, of which I am an original cosponsor, is designed to provide a partial answer to that question.

This morning in this very same committee, we discussed the issue of media monopolies. I raised the question of who owns our great television networks. Should we concern if these networks are owned and run by somebody totally unrelated to broadcasting or the entertainment industry. Who is really concerned with finding who really runs these companies? What are the intentions of these companies? Where is the public interest being protected.

I have read the statements of today's witnesses. I am disappointed that we do not have an opportunity to hear from the CNW management or the Japonica partners.

I would also like to commend my colleague, Senator Harkin from Iowa, and Senator Kasten as well as Senator Exon. They have all been on the front line of this issue, and we are working together.

Senator EXON. Thank you very much, Senator Pressler, and I would like to advise the Chairman and also the other witnesses that there very likely will be several questions for the record of both this panel and the ones that will follow that we would appreciate as prompt an answer as possible.

And I will particularly be looking forward, Chairman Gradison, to what kind of a bill or wording of a bill that maybe you and I could agree on and look forward to amending this bill because I think I speak for Senator Harkin and the cosponsor, the Senator from South Dakota, and myself that we have no preconceived ideas that this is written in stone. We want to have a workable bill.

I just would like to comment that while it is not directly in the railroad industry, I am very fearful of it happening, and when I talk of it, I am talking about Eastern Airlines. So, at least in the Senator's opinion, that is a clear case of somebody taking over an airline who did not want to operate an airline at all. They wanted to raid it, and I think that is bad for the nation, but I think it would be even worse for parts of this nation if we could have a similar situation with regard to railroads.

And that is the type of legislation that I think most of us are interested in, and we feel that very properly that belongs in the Interstate Commerce Commission.

But if you would make some suggestions in that area, we would appreciate it very much.

I have—well, let me ask you one other question because I am sure it is going to come up and I do not know whether you are aware of the position of the Iowa Department of Transportation or not, but as I understand it, the Iowa Department of Transportation will testify later today that the leveraged buyouts may increase, may increase the ICC's total cost of capital calculation.

The current 9.7 average cost of railroad bond debt could be replaced by junk bond interest rates of 16 to 17 percent or more. The 17 percent, as in the Blackstone offer for the CNW Railroad is an example.

In addition, rates of return to leveraged buyout transactions are generally expected to be much higher, maybe as much as 40-50 percent per year. If that is true, might this mean higher rates for shippers, further abandonments of branch lines and declining investments in track and rolling stock? I think the answer to that is yes.

Now, it might be argued well, those are all iffy things, that they might not happen. But we are talking about real case scenarios where things like that did happen and that basically I think is a concern of those of us who have oversight responsibilities in the surface transportation area.

Do any of those things that I have just cited cause you any pause for concern and if so, how do we address it to the ICC or some other agency of the government?

Ms. GRADISON. I go back to the opening remark that I made which is that ICC review is not a guarantee of success. ICC review is not a guarantee of ongoing successful operations.

And while we look at each component of the cost of capital, that you expressed a concern about, that Iowa DOT is concerned about, first of all, it is a guideline, and it is but one component in the domino scenario that Iowa DOT spells out.

The Interstate Commerce Commission is today charged with dealing with each one of those concerns, and we have tools which we use when those concerns are brought to us.

If you would like I could have our director of accounts Dan Campbell who is to my left address the specific cost of capital question.

Senator **Exon**. I would be happy to. Mr. Campbell.

Mr. **Campbell**. This relates really to the first part of the Iowa question and that is whether or not the addition of new debt would change the cost of capital figure at the Interstate Commerce Commission. It would, but it wouldn't necessarily raise it because what happens in one of these transactions is that it is equity, the common equity, costs that are pushed out. It is not the lower cost debt. The lower debt would continue to be there.

It is true that the new debt may come in at a higher rate, but when we look at the cost structure of the industry, we are comparing both equity and debt cost, and what we would see here is more debt, less equity. Equity is typically much higher than the debt that we have seen. I think the Chairman noted it is about three points higher than common equity. So, what you would get is you would get higher cost debt, but it would be pushing out higher cost equity. And so I think on that issue you probably get a wash at best.

Senator **Pressler**. Mr. Chairman, when you get through, I would like to follow up.

Senator **Exon**. Please go ahead and follow up right now, Senator Pressler.

Senator **Pressler**. Well, on this where the money flows and so forth, I know that in these big buyouts that is the way it has to be. But who should, if not the ICC, review for the public interest—this is something that concerns me, and I know that on these takeovers and so forth it is where the money flows, where the highest return is.

But, as a point of view of public administration, I am concerned with if not the ICC who should hold groups like Japonica responsible for its representation or its plans once a railroad is acquired. I guess what I am saying here is in the old days, so to speak in the romantic days, the people who owned something, you could call them in here and have them as witnesses.

This morning we had three television networks here of which only one, Mr. Tisch, was actually running the network he owned. Of the other two, one was owned by GE and the other by somebody else.

Analogously in railroads, this committee might call the president of the railroad in here, but he or she is three or four layers up and so forth. I mean, maybe we are in need of a new era of I hate to use the word regulation because I have been in favor of the concept of less regulation. But if not the ICC, who should hold those groups responsible?

Ms. **Gradison**. We do, and we did have Japonica come before us and any debt that Japonica had, that the railroad issued would clearly come before the Interstate Commerce Commission.

So, we do have the jurisdiction to participate in these transactions at some point or another. It is just that we do not play a role necessarily up front for non-carrier acquisitions. And my point that we should not or that it would be difficult for us to do so is—it is hard to know when the dance is over. If we had undertaken an extensive review of the Japonica offer, the commission would still be doing it and the offer would no longer be on the table.

At what point does our jurisdiction begin? At what point does it end? Will it depress rail value on the market? We are concerned that this industry is finally competitive and attractive, and we do not want to see its value depressed in the general market.

We have a responsibility to see that the rail infrastructure is maintained, and we have the tools to do that today, and we use those tools. And in the instance of the Japonica group proposed buyout, we used our broad reach to invite them in and to tell us what they were about and to tell us what their plans were. And they were most cooperative eventually.

Senator PRESSLER. I very much appreciate the leadership you showed in those hearings, and I stayed for the whole hearing that day which is maybe unusual because I was trying to learn.

But I am fascinated with the bigger picture. We are in a new era in terms of Congress' or government agencies' relationships to what we traditionally have thought of as regulation. In the old era, the ICC or the Congress was dealing directly with transportation companies, be it a railroad or an airline, and if we called in Northwest Airlines, we were really talking to Northwest Airlines.

Now we are in this era of these corporate takeovers and we might be talking to somebody that is the president of the company but he is three or four layers of ownership down. And how Government responds in this new era is very important. I think we are groping for how to take the approach because we really do not know how to determine the intention of a takeover group even if they show their plan. For example, I am very concerned about short line railroads. I am going to dedicate a junction in Rapid City, South Dakota soon on a short line railroad, but they depend totally on the main carriers. And they would be buffeted about by a major takeover in terms of what the commitments have been made by the previous railroad.

What I am saying is that maybe there is a solution. Maybe we are groping for a whole new approach on how to deal with companies that have public transportation or a public responsibility in my view which are taken over in these huge corporate takeovers. We do not know who we are talking to, and that is the way I felt about Japonica and that is why I worked to get that hearing, and I thank you very much for it.

I do not know if you have any response. Are we in a new era in our relationship with these companies or has nothing changed?

Ms. GRADISON. I really do not have a response.

Senator EXON. Thank you, Senator Pressler.

Senator Robb.

Senator ROBB. Mr. Chairman, I am going to pass at this point. I did not hear the initial statement. I had a couple of questions that I suspect have been answered, and I will check on the record.

Senator EXON. Thank you, Senator.

Thank you very much, Madam Chairman.

Senator PRESSLER. Mr. Chairman, I have just one more. Commissioner Lambaley says legislation like S. 1005 simply clarifies, not creates, ICC jurisdiction. Is that the general agreement of everybody here?

Ms. **Gradison**. No, sir.

Senator **Exon**. No, I think that is probably not the general agreement, and that is one of the major bones of contention, but there are some other questions, Madam Chairman, that I will have for the record and that I would appreciate your responding in your usual prompt fashion. Thank you very much, and you are excused.

Our next panel, Mr. James J. Kennedy, Executive Secretary of the Railway Labor Executive Association, and Mr. Darrel Rensink, Director of the Iowa Department of Transportation.

Gentlemen, if you will please take your place at the table. I have not been advised which of the witnesses would like to go first and, therefore, unless there is some objection from either of you, I will recognize Mr. Kennedy first for his presentation.

STATEMENT OF JAMES J. KENNEDY, JR., EXECUTIVE SECRETARY-TREASURER, RAILWAY LABOR EXECUTIVES' ASSOCIATION; ACCOMPANIED BY WILLIAM MAHONEY; AND JOHN O'BRIEN CLARK

Mr. **Kennedy**. Thank you very much, Mr. Chairman. Senators Pressler and Robb, we certainly appreciate the opportunity to speak on a subject that has caused such great distress among the railroad employees of this Nation.

We certainly appreciate this opportunity you have given us, the promptness with which you have called these hearings, and I did want to congratulate and thank Senators Harkin and Pressler for moving, recognizing and responding to this problem. We appreciate that very much.

Our members, employees on our Nation's railroads, have felt the adverse effects of the leveraged purchases of short lines and regional railroads throughout this country. The most significant effect upon employees has been the loss of employment by people who have served their employers for many years and served them well.

For the most part, these people are too old to find decent alternative employment and too young to retire. They are at a stage in life when their fixed obligations are at their greatest. In addition, many have children in college, which as you know is an extremely expensive undertaking today.

As noted in my prepared statement, railroad employees have lost some 30,000 jobs as a result of sales to create short lines and regional railroads.

We cannot know precisely how many miles of road that have become short line and regional railroads since 1980 would have been abandoned without the ICC's innovative interpretation of the Interstate Commerce Act provisions that ignited the short line explosion.

However, one might reasonably conclude that most of the lines forming the 12,200 miles of regional railroads would not, or could not, have been abandoned during that period. Even the most liberal application of the Staggers Act would not have permitted abandonment of the large rail networks that formed the regionals, nor would the railroads have deprived themselves of the significant traffic fed to them by those lines.

The rapid development of short lines over the past eight years has been accomplished, to a large extent, by the device of the leveraged buy-out. The debt burden upon each of the short lines created by these leveraged purchases must be serviced and it can only be serviced by very low cost, relatively high revenue operations.

The financial burdens under which most of the short lines operate has already resulted in a number of bankruptcies among this new generation of railroads. As pointed out in more detail in our prepared testimony, some 22.6 percent of the railroads created from 1981 through 1987 have failed and most of the failures were caused because the newly-created railroads simply could not service their enormous debt.

Many of the remaining short lines and regionals, because of the leveraging aspect of their purchase, remain in precarious financial posture susceptible to a cessation of operations at the next serious economic recession which strikes this Nation.

The Commission does not inquire as to the financial viability of the purchasers of these lines. It does not now do that. Instead, when a party challenges the financial viability of a proposed purchase, the Commission requires the challenger to prove the applicant's operation would not be viable rather than requiring the applicant to prove that its operations would be viable.

We point that out in an example of this on pages 7 through 9 of our prepared testimony—by the way, in an area where the Commission already agreed that it had jurisdiction but it did not exercise this jurisdiction to protect against the same kind of problem this legislation is designed to address.

In the case there discussed, rail labor challenged the financial viability of the proposed operation on the basis of the information which the applicant itself had presented to the Commission. The Commission said we had not proved that the new carrier would not be viable and therefore permitted it to go forward. One year later, that railroad went into bankruptcy because it could not service its debt.

We are now having very serious problems throughout this country with some of the effects of deregulation. We have seen what it has caused in the savings and loan industry. We are seeing what it is causing in the airline industry, as the number of airlines dwindle to a monopolistic few and the quality of service declines and the fares and airline profits rise.

Here, in the railroad industry, we will see its effects in the next severe recession, when many—perhaps none—of these leveraged carriers can meet their financial obligations and they declare themselves cashless and cease operations. The government will then be confronted with buying them up with taxpayer's money in order to preserve our rail network, or hope that the Class I railroads will buy up some of them to preserve their own traffic.

S. 1005 seeks to have the Commission investigate the purchase of Class I carriers by noncarriers and it is a step in the right direction. But we believe it is too restrictive in its application and too general in its terms.

We respectfully suggest that it be made more specific in its directions to the Commission as to what the agency must and what it must not do, and I would submit that Chairman Gradison's testimony demonstrates that, and it should be made applicable to all purchases of all carrier properties by all potential purchasers, carriers and noncarriers alike.

We suggest this because the Commission today is operating at a full deregulation mode, all full speed ahead. It has the deregulation bit in its teeth and it will not respond to gentle tugs on the reins as to the direction in which Congress wishes it to travel.

Unless the Commission is specifically directed by this Congress to perform a specific act, it will not only refrain from performing that act, but it will declare the Congress does not indeed want it to perform such an act because it did not specifically direct it to do so.

Based on our experience before the Commission in recent years, I am certain that the meaning of such terms in S. 1005 as "significant diminution or deterioration of service" and "adequate level of service consistent with the public interest" will have meanings to the Commission quite different from those Senator Harkin and Senator Pressler had in mind and those Congress might have in mind.

[The statement follows:]

STATEMENT OF JAMES J. KENNEDY, JR., EXECUTIVE SECRETARY-TREASURER, RAILWAY LABOR EXECUTIVES' ASSN.

My name is James J. Kennedy, Jr. I am Executive Secretary-Treasurer of the Railway Labor Executives' Association to which I was elected by the members of the Association. The offices of the RLEA are located at 400 First Street, N.W., Washington, D.C. 20001.

The RLEA is an unincorporated association whose members are the chief executive officers of the standard national and international railway labor organizations, which I list below, representing most of the contract employees on the railroads operating in the United States.

The employees of the railroads of this nation, perhaps more than any other segment of the public interest, have felt the adverse effects of the leveraged purchases which have so significantly contributed to the recent development of short line and regional railroads in this country. These effects are evidenced not only in the loss of employment for people too old to find decent alternative employment and too young to retire but in the loss of contractual and statutory rights and, for many of those who do obtain employment, in the inability to exercise the skills which they have developed over years of employment by Class I railroads.

The loss of employment in the railroad industry as a result of the I.C.C.'s creative interpretation of the Interstate Commerce Act so as to carry out the "spirit of the Staggers Act," has been substantial. In 1980 Class I railroads employed an average of 2.78 employees per mile of road owned and in 1987 employed about 1.88 employees per mile. The many short lines that existed before the enactment of Staggers operated about 19,200 miles of road as of 1987 and employed 28,600 people or 1.49 employees per mile.

In October, 1987, RLEA Chairman Richard I. Kilroy testified before the House Energy and Commerce Committee, Subcommittee on Transportation, Tourism and Hazardous Materials, on the rapid growth of short lines and its effects upon employees. At that time he submitted the names, length and number of employees of all short lines and regional railroads listed by the I.C.C. and A.A.R. as having been created subsequent to the enactment of the Staggers Act, as well as a list of pre-Staggers short lines. These lists were reproduced in the hearing record and are attached to this testimony for the convenience of the Subcommittee.

In 1987 the 34 post-Staggers short lines over 100 miles in length owned 12,200 miles of road with 3,800 employees averaging .31 employees per mile. The largest of these is Wisconsin Central R.R. with approximately 1,960 miles owned and operated and an estimated 800 employees (as of October, 1987) or .40 employees per mile. In October, 1987, all post-Staggers short lines owned about 16,000 miles of road and employed about 4,600 people or .2875 employees per mile.

Since those short line and regional railroads were created from Class I lines employing 1.88 employees per mile, a comparison of the number of people employed in connection with those lines before and after they were sold reveals a loss of 30,000 jobs to the Class I's. If one subtracts the 4,600 jobs provided by the short lines, a net total of 25,400 jobs is lost to the industry. The sales to the regionals alone, with 12,200 miles of road, meant the loss of 22,936 jobs to the Class I's and a net loss of 19,136 jobs to the industry.

There is, of course, no way of knowing how many of the miles of road that have become short line and regional railroads since 1980 would have been abandoned without the I.C.C.'s innovative interpretation of the Interstate Commerce Act's provisions that ignited the short line explosion; however, one might quite reasonably conclude that most of the lines forming the 12,200 miles of regional railroads would not or could not have been abandoned during that period: the Montana Rail Link (830 miles); Washington Central (433 miles); Wisconsin Central (1800, plus 173 trackage rights); Mid-South (474 miles); Chicago Central and Pacific (772 miles); Dakota, Minnesota and Eastern (965 miles); Red River Valley and Western (656 miles); Chicago, Missouri and Western (631 miles), etc.

Even the most liberal application of the Staggers Act would not have permitted abandonment of such large rail networks nor would the railroads have deprived themselves of the significant traffic fed to them by those lines. However, if such abandonments had occurred, the employees affected by them, unlike employees economically injured by line sales, would have been protected in their compensation for six years, thereby allowing most of them to adjust to their new economic situations.

If the lines that became regional railroads could not have been abandoned, the mileage and jobs lost to Class I railroads and their employees would have been far less than actually occurred between 1981-1988 absent the line sales.

While the conclusions set forth above regarding loss of employment due to the creation of short line and regional railroads between 1980 and 1987 may not be definitive, they do provide a reasonable indication that the loss of employment in the industry due to short-lining has been significant.

The loss of job opportunities by men and women too young to retire, too old to secure decent alternative work, with few saleable skills outside the railroad industry, and at a time in life when their fixed obligations are often the greatest (mortgages, children in colleges, etc.), is by no means the only loss suffered by employees affected by the short line phenomenon. The 4,600 people hired by short lines as of October, 1987, or as many of them as had previously worked for Class I railroads, for the most part lost their contract and statutory rights as the Commission held its orders, not the Railway Labor Act or the contracts, "govern employee-management relations in connection with" transactions it approves.

However, in addition to the extensive and severe economic injury which has already been visited upon railroad employees and their families by the short line sales, there is another aspect to this venture in I.C.C. policymaking which threatens the economic life, not only of those who now work for these new railroads, but also, of many employees who continue to work for Class I railroads, as it threatens the economic life of those railroads for which the short lines act as feeders of traffic.

The rapid short line development over the past eight years has been accomplished to a large extent by the device of the leveraged buyout: the purchasers invest little money of their own and mortgage all of the assets they purchase to raise the cash to buy them. The enormous financial burden thereby created must be serviced by very low cost, relatively high revenue operations. Very often the selling carrier provides most of the short line's locomotive power and cars under a lease arrangement. And, because most of the short lines are created from branches or secondary main lines of Class I carriers, they connect only with the selling carrier leaving them totally dependent upon the will of their single connecting carrier.

The financial burdens under which most of the short lines operate has resulted in a number of bankruptcies among this new generation of railroads. According to a recent article in an issue of the magazine Modern Railroads devoted to short line and regional railroads, in the years 1981 through 1987 some 33 newly created short lines and regionals failed; or, approximately 22.6% of the 146 short lines and regionals created during that time. Most of these failures occurred because the newly created railroads could not service their debts. Had these lines not been sold and had been kept in service, the shippers would have continued to have been served and the employees would have continued to work with their statutory and contract rights preserved. If the lines were not economically viable in any event and had to be abandoned, then, although service would have ceased, at least the employees affected by the abandonments would have been accorded the protections this Congress mandated they should receive upon abandonment. Under the Commission's application of the Act the employees receive nothing.

Many, if indeed not most, of the remaining short lines and regionals, because of the leveraging of their assets, remain in a precarious financial posture susceptible to a cessation of operations at the next serious economic recession which strikes this nation.

The Interstate Commerce Commission, rather than acting as the watchdog of the public interest on the issue of the economic viability of a purchaser, is more like the three monkeys who see, hear and speak no evil. For example, in 1986 the Venango River Corporation formed a new subsidiary company, the Chicago, Missouri & Western Railway Company, to acquire a 631 mile line of railroad from the Illinois Central Gulf. Venango filed a notice of exemption from the requirements of Section 11343 of the Act. Since Venango already controlled the Chicago, South Shore & South Bend, its control of a second railroad was subject to Section 11343 rather than Section 10901. Over the objections of the RLEA and individual labor organizations and representatives, the I.C.C. permitted the exemption to take effect and then refused our request for a hearing and refused to revoke the exemption. Rail Labor had challenged the financial viability of the proposed CM&W railroad but, without a hearing, the I.C.C. accepted Venango's viability claims at face value. Rail Labor filed a petition to reopen in which it said:

> "The Commission faults protestants [labor] for not demonstrating why the proposed transaction would not be viable. [Emphasis in original.] (Decision, p. 4). This has a bearing on the rail transportation policy and market abuse criteria of section 10505.[6] Of course, as already indicated, the failure to conduct a hearing deprived protestants of an opportunity to examine CM&W, Venango, and ICG officials.
>
> The burden of proof should rest with CM&W and Venango to demonstrate viability . . . ."

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[6] The Commission recognized that where a transaction may threaten continuance of service, "market abuse" is involved. Railroad Consolidation Procedures, 1 I.C.C. 2d 270 (1985).

On May 5, 1987, the Commission rejected Rail Labor's petition and dismissed its above-quoted argument in the following words:

> Except for one matter noted below [that the transaction was a subterfuge to avoid employee protection] petitioners [labor] essentially raise the same issues and make the same unsupported arguments with respect to those issues which they advanced on behalf of the stay petition and the petition to reject or revoke the notice of exemption. We find it unnecessary to address further those arguments, as we have already fully and correctly disposed of them. Since we also do not find merit in petitioners' new argument, we affirm the prior decisions.

The Chicago, Missouri and Western began operations in April, 1987; it went bankrupt on April 1, 1988; it was not a financially viable operation; it could not service its debt.

Thus far the country has been extremely fortunate that only railroad employees and their families have had to bear the brunt of the economic injury caused by the I.C.C.'s creation of the short line phenomenon "in the spirit of the Staggers Act."

The Staggers Act contained no amendments to the Interstate Commerce Act indicating or even implying that railroad employees should be treated under the Interstate Commerce Act any differently than they had been treated in the past. However, the Commission viewed deregulation, even partial deregulation, of the rail industry in quite a different light.

The Commission opined that the Congress in 1980 had not completed its task; that while it had removed many of the regulatory burdens of pricing, and entry and exit, it also must have intended to remove the carriers' regulatory burdens evidenced by the protections provided employees in abandonments, sales and mergers and finally, by the obligations encumbering managements found in the Railway Labor Act and collective bargaining agreements. The Commission thereupon set out to remove those burdens from rail management and to a large extent has succeeded in doing so with the concurrence of the courts who necessarily view the I.C.C. under our system of jurisprudence as the expert in the administration of its own statute, the Interstate Commerce Act.

Eventually, however, this deregulation dam will break. It will break because human nature is unchanging. Without positive, constructive regulation, society would become chaotic and so would each segment of society. Any society based upon capitalism and the profit motive is susceptible to domination by greed unless reasonably controlled by regulations. It was necessary to enact such regulations in 1887 with the creation of the Interstate Commerce Act. It is becoming more apparent that reasonable regulations are necessary today.

The deregulation dam has broken with the Savings and Loan scandal where officers of those companies had virtually unbridled access to billions of dollars of other people's money and quickly and greedily took advantage of their position. The airline deregulation dam has a crack in its face that widens each day as we see the number of airlines dwindle to a monopolistic few, the quality of service declines and the fares and airline profits rise.

The railroad deregulation dam, at least the Commission's unilateral contribution to it, will break with the next severe prolonged recession as the leveraged short lines and regionals, lacking sufficient revenue or unpledged capital bases, declare themselves cashless and cease operations. The country will then be left with a choice between buying up these lines to keep them in operation at taxpayers' expense or hoping the Class I railroads dependent upon them buy back or agree to operate enough of them to avoid a crippling blow to our rail freight system.

S.1005 seeks to have the Commission investigate purchases of Class I carriers by non-carriers. But it is restricted to Class I purchases and is written in general terms. The Commission today is operating in a deregulation mode. It has the deregulation bit in its teeth and will not respond to gentle tugs on the reins with general instructions as to the direction in which Congress wishes it to travel. Unless it is specifically directed by this Congress to perform a specific act, but, it will not only refrain from performing that act, it will declare that Congress does not want such act to be performed.

RLEA respectfully submits that if S.1005 is to be effective, it must be made specific as to I.C.C. duties and it must be expanded to include all purchases of carrier properties by all potential purchasers, carriers and non-carriers alike.

Senator EXON. Thank you very much, Mr. Kennedy, and I will have some questions for you in just a moment. The good news is, I had no trouble hearing you whatsoever.

Mr. Rensink, we are particularly pleased also that you had enough interest to come in and testify on this measure that is so vital to the State of Iowa and I am very pleased to recognize you at this time.

STATEMENT OF DARREL RENSINK, DIRECTOR, IOWA DEPARTMENT OF TRANSPORTATION

Mr. RENSINK. Thank you, Mr. Chairman. I am Darrel Rensink, Director of the Iowa Department of Transportation, and I would like to say at the beginning we certainly commend our senator from Iowa, Senator Harkin, for sponsoring S. 1005.

We support this initiative as indicated by our testimony here today. Iowa extends deep appreciation to the Subcommittee for holding this hearing on legislation to specify that the ICC has jurisdiction over the buy-outs of railroads and railroad holding companies by noncarriers.

This is key to the future of rail transportation and Iowa strongly supports this corrective legislation. The noncarrier issue is before you because of leveraged buy-out activity for CNW corporations and indications of leveraged buy-outs for other railroads throughout the Nation.

For decades a major goal of Congress has been to improve the financial stability of railroads. Through the 3R Act, the 4R Act and the Staggers Act, you have worked to revitalize American railroads through such positive steps as permitting railroad rate flexibility and allowing the creation of regional and short line railroads. You have also wisely invested billions of taxpayer dollars in the Nation's railroad system.

By way of background, Iowa was one of several Midwestern states to oppose the Gibbons, Green Van Amerongen buy-out of CNW in late 1987, and the recent Japonica partners leveraged buy-out. We are currently reviewing the recent Blackstone offer.

The State of Iowa took these positions because the heavy debt loading in these transactions is a massive drain on transportation assets for nontransportation purposes.

When a railroad is taken over in a leveraged buy-out, either hostile or friendly, there is typically a huge new debt load created, yet the proceeds of the debt are not used to purchase productive assets such as track and locomotives and the takeovers also typically bring no new revenues. So a leveraged buy-out may drain cash from the railroad to pay off debt with absolutely no benefit to the railroad.

We are deeply concerned about the impacts of these transactions. The legislation under consideration by this Subcommittee would extend ICC jurisdiction to purchases of railroads by noncarriers.

The question we are asked is, why should the public care? The answer is that railroads are a unique industry, providing a public service vital to the Nation's economy. For this reason, you have long mandated that railroads must have ICC approval in order to stop service.

Because of their important role railroads must be managed as going concerns, businesses that must continue to provide service and businesses that require a long-term perspective, not the short-term perspective typical in leveraged buy-outs.

If it did not matter to our economy if a railroad ran out of money or deferred track maintenance and increased abandonments, then we would not be testifying here today. The fact is, however, it does matter a great deal. Congress and the states have demonstrated this through a history of public investment in railroads and regulation of major railroad transactions.

ICC jurisdiction over mergers and acquisitions of railroads has focused only on transactions involving two or more carriers. The ICC has been concerned with possible impacts of the transactions, such as potential rate increases, diminished quality of service, loss of market access and increased abandonments.

However, impacts from leveraged buy-outs can include potential rate increases, increased branch line abandonments, loss of market access, increased transit times, deferred maintenance and potential railroad bankruptcy.

These are the same adverse effects Congress has directed the ICC to regulate in regard to other railroad transactions. It is just plain common sense to bring leveraged buy-out transactions involving railroads under the clear jurisdiction of the ICC.

You must act quickly and pass remedial legislation in this area. It has been proven there is a profit to be made in leveraged buy-outs of railroads. Other railroads may be targets soon.

Wall Street is already publishing reports that show at least six other Class I railroads are likely targets, including Norfolk Southern, Conrail, Santa Fe, Burlington Northern, CSX and Soo Line.

Our written testimony includes a number of points which we feel should be included in any bill of this nature. The most important points I want to stress are, one, any legislation must apply to acquisitions of railroad holding companies. The legislative and ICC history on this issue is too confused to allow the holding company jurisdictional question to remain undefined.

Two, open public access must be assured. ICC's railroad merger proceedings have included detailed material that is just as sensitive as that which is contained in leveraged buy-out proposals, yet these ICC merger proceedings have always been open to the public. We urge you to resist any proposal to close off railroad leveraged buy-out transactions from public view.

In closing, Congress has done an excellent job of restoring the Nation's railroads to economic health. If all of your past efforts are to have meant something, Congress must act to bring these transactions under ICC jurisdiction.

Mr. Chairman, thank you very much.

[The statement follows:]

STATEMENT OF POSITION OF THE
IOWA DEPARTMENT OF TRANSPORTATION

Iowa wishes to strongly commend the Subcommittee for holding this hearing on S.1005 and similar legislation to correct a loophole in Title 49 U.S. Code and provide the ICC jurisdiction over buyouts of railroads and railroad holding companies by non-carrier parties.

Iowa DOT is interested in this issue because as the designated state agency in rail matters, it is responsible for the planning, development, improvement, and intrastate regulation and supervision of railroads in the state of Iowa.

REASONS FOR OPPOSITION TO LEVERAGED BUYOUTS OF RAILROADS

The Department submitted Comments and presented testimony in the recent Interstate Commerce Commission Ex Parte 480 proceeding wherein we expressed our opposition to the proposed leveraged buyout (LBO) of CNW by Japonica Partners Ltd. A copy of the Comments on Behalf of the Iowa Department of Transportation in that proceeding is attached as Appendix 1 to this Position Statement. Iowa also formally opposed the late 1987 proposed leveraged buyout of CNW by Gibbons, Green van Amerongen. We have not taken a position on the current Blackstone/Management/UP offer for CNW and currently have it under review.

The State of Iowa took these positions because we see the heavy debt loading in these types of transactions as a massive drain upon transportation assets for non-transportation purposes. When a railroad is taken over in a leveraged buyout--either hostile or friendly--there is typically a huge new debt load created. Yet, the proceeds of the debt are not used to purchase productive assets such as track, locomotives, and intermodal facilities. The transactions we opposed also did not bring any new operating or labor agreements, and no new revenues. They would simply have drained cash out of the railroad to pay a debt load whose sole purpose was to transfer ownership and control of the company into the hands of a small group of individuals. The impacts upon the financial stability of the railroad and resultant effects upon transportation would be severe. We therefore see a need for ICC authority over such transactions.

FINANCIAL STABILITY AS GOAL

For many years it has been a major goal of the Congress to improve the financial stability of U.S. railroads. Through the 3R Act, 4R Act, Staggers Act and ICC rulings, the Congress and the Commission have worked to eliminate burdensome regulations, improve rate making flexibility, rationalize systems, and in numerous other ways have worked to improve the financial status of American railroads so that they may adequately serve shipper needs. Literally billions of dollars in taxpayer funds have been invested in the nation's railroad system to achieve this goal.

Iowa DOT and other midwestern state DOTs have supported Congressional efforts to accomplish this goal, as we have seen first hand the impacts when railroads lose financial ability to reinvest in their systems. The states have also helped strengthen railroads by providing financial assistance for track rehabilitation and other physical improvements.

These efforts are now beginning to show positive results. Railroad debt levels are falling, profits are improving, and the ability of railroads to make capital investments in transportation is now greatly increased.

After well over a decade of Federal and state action, including substantial public investments to improve the health of U.S. railroads, this health is now threatened by leveraged buyout proposals for our railroads. If the railroad industry financial stability which the Congress and the states have worked so hard to achieve is not to be jeopardized, then transactions of this nature must be recognized for the direct and substantial threat they pose to national transportation.

SHORT-TERM THINKING VERSUS "GOING CONCERN" NATURE OF RAILROADING

Railroads are a unique industry poorly suited to leveraged buyouts, as they provide a public service vital to the nation's economy. For this very reason Congress has mandated for decades that railroads cannot cease to provide service without ICC approval. It is essential for the national interest that railroads be managed as "going concerns"-- businesses that will continue to provide service. A "going concern" cannot liquidate its physical plant or deliberately go out of business. It must also reinvest capital for the future if it hopes to survive in the long run. A "going concern" business requires a long-term perspective, not the "liquidation" perspective typical of LBO's.

It is not in the national interest to allow our nation's railroads to operate in an environment which essentially requires that they always be highly leveraged and financially insecure. This can only lead to "short term thinking" which can cause deferral of capital reinvestments which are needed for the long-term provision and improvement of rail service.

We have seen this familiar pattern before, when short-term dividend policies on some railroads caused deferrals of track maintenance that ultimately led to the collapse and bankruptcy of these systems. It could happen again. In today's environment, the possibility that a target railroad may go bankrupt 10 years from now may not be a primary concern of LBO sponsors, who may only feel a need to get through a 5 or 7 year leveraging period.

A longer-term perspective must be applied to these transactions. Public interest criteria must play a paramount role to protect the viability of our nation's rail transportation system so vital to our economy and national security.

PUBLIC INTEREST CONCERNS ASSOCIATED WITH THE ACQUISITION OF RAILROADS AND RAIL HOLDING COMPANIES BY NON-CARRIERS

If two or more railroads wish to merge, or one railroad desires to acquire another railroad, the Interstate Commerce Commission (ICC) has the responsibility to review the proposed transaction to determine how other railroads and the general public will be affected. Also, if a non-carrier acquires a railroad or a railroad holding company, the ICC has the authority to review actions subsequent to the acquisition that would involve the abandonment or sale of railroad operating properties. On the other hand, the ICC maintains it has no jurisdiction to review a non-carrier's acquisition of control of a railroad or railroad holding company.

When a non-carrier wishes to acquire a railroad or railroad holding company there would probably not be any concerns about intramodal competition and market share such as are associated with a transaction involving two or more railroads. However, numerous public interest concerns can arise from non-carrier transactions.

The public interest concerns that arise from the acquisition of a railroad or railroad holding company by a non-carrier relate to the general question of how the nation's economy would be affected by the transaction. This type of transaction could possibly affect the cost, quality and the availability of rail service. As a consequence, shippers' access to markets, the prices they must charge for their products, and the quality of service they are able to provide to their customers could all be adversely affected. Concern over the possibility of these adverse impacts is heightened when the transaction burdens the railroad with a substantial increase in debt.

Following are several public interest concerns which are pertinent to any railroad buyout:

1. Will increasing the debt load of the railroad, or railroad holding company, result in a higher cost of capital for the firm? If leveraged buyouts occur throughout the U.S. railroad industry, will this cause the ICC calculation of railroad industry cost of capital to rise and therefore affect ALL ICC rail regulatory proceedings?

The railroad "cost of capital" is a key computation used by the ICC in nearly all of its regulatory proceedings--including abandonments, rate proceedings, and revenue adequacy determinations. If U.S. railroads' cost of capital rises, then it becomes easier to justify abandonments, rate increases, and other actions adverse to shipper interests.

The recent ICC cost of capital calculation for 1988 (Ex Parte No. 478, Decided April 27, 1989) concluded that the U.S. railroad industry's current weighted average cost of capital is 11.7 percent. This cost of capital was based upon the current financial structure of U.S. railroads which is comprised of: (1) a current cost of debt of 9.7 percent; (2) a current cost of preferred equity capital of 7.1 percent; (3) a cost of common equity capital of 12.7 percent; and (4) a 31.0 percent debt/68.4 percent common equity/0.6 percent preferred equity capital structure mix.

While some argue that debt is actually cheaper than equity, and therefore a company's total cost of capital can be reduced by replacing equity with debt, this does not take into account the fundamental transformation of the nature of the company when major new leveraging is imposed. The costs of both debt and equity are directly related to the perceived riskiness of the company. A highly-leveraged company is a more risky company and therefore lenders charge higher interest rates and equity holders expect higher returns than for a more stable company.

As Robert C. Higgins, Ph.D., Professor of Finance at the Graduate School of Business at the University of Washington, notes in his book, Analysis for Financial Management:

> "Some persons...naively conclude that it is possible to reduce a company's weighted-average cost of capital by using more of the cheap source of financing, debt, and less of the expensive source, equity. In other words, they conclude that increasing leverage will reduce the cost of capital. However, this reasoning evidences an incomplete understanding of leverage...[I]ncreasing leverage increases the risk borne by shareholders. And because they are risk adverse, shareholders react by demanding a higher return on their investment."

Consider what may happen to railroad cost of capital if U.S. railroads become highly-leveraged through a wave of LBO's. The current 9.7 percent average cost of railroad bond debt, indicative of "low risk" interest rates, could be replaced by "junk bond" interest rates of 16-17%.

The current 7.1 percent cost of preferred equity capital (which is weighted by the existence of low-cost FRA preferred equity which would typically be bought out in any LBO) may rise to the 17% preferred equity cost as seen in the current Blackstone offer for CNW.

The current cost of common equity capital of 12.7 percent would be replaced by the common equity capital of the LBO buyers. Although this number is hard to calculate as LBO common stock is not publicly traded, LBO industry sources indicate typically expected rates of return in LBO transactions are 40% - 50% per year.

Finally, instead of a current debt-to-total capitalization ratio of 31%, the U.S. railroad industry may find itself saddled with debt-to-capitalization ratios of 70% - 85% typical of LBO transactions.

If this type of capital structure became common in the U.S. railroad industry, the ICC's total cost of capital calculation may rise. This therefore would make it easier for all U.S. railroads to justify abandonments, rate increases, and a host of other ICC regulatory actions which have direct impacts upon shipper interests.

2. Will increasing the debt load of the railroad, or railroad holding company, result in higher transportation costs for shippers?

How high a railroad can raise its rates depends on the availability to shippers of competitive alternative transportation. Captive shippers without many transportation options could be forced to pay higher freight expenses to help pay off the railroad's increased debt load. This problem may be compounded if the new debt loading causes ICC cost of capital calculations to increase the rates that the railroad can "reasonably" charge to captive shippers under rate regulation.

Rates could also be increased if portions of the railroad must be liquidated to retire the new debt. This could result in single line hauls becoming segmented among two or more carriers which would likely result in increased rates.

3. Will increasing the railroad's debt load result in more branchlines becoming subject to abandonment?

Most companies set a threshold rate of return for making new investments and for maintaining existing investments, which is usually tied to their cost of capital. If the assumption of new debt raises the railroad's required cost of capital this could increase the amount of branchline railroad lines that become subject to abandonment, as fewer lines will be able to meet a higher standard. Even if there is no formal increase in cost of capital, the increased demand for cash from the leveraging will increase pressures to liquidate marginally productive lines.

4. Will market access be affected if portions of the railroad have to be liquidated to retire debt?

Following passage of the Staggers Rail Act many railroads elected to close interchange points and cancel joint rates. If portions of the railroad must be sold to reduce the debt assumed for the takeover, shippers that used to have single line access to markets could find they no longer possess the same rail options or market access as before the transaction. Far beyond just the question of rail rates, the possibility of actual closure of markets may drastically affect many shippers' businesses.

5. Will transit times be affected if portions of the railroad have to be sold to retire debt?

In recent years as concern about inventory costs has increased, reducing the amount of time required to move freight has become of added importance. If portions of the railroad are sold this may increase the number of carriers participating in the movement of a shipper's freight. As a consequence the number of times freight is interchanged would increase and this may result in an increase in transit time for the affected freight shipments.

6. Will the railroad's ability to maintain and improve its track facilities and rolling stock be affected by an increase in debt load?

If the railroad's debt load is increased as the result of the takeover its ability to invest in track improvements and new rail cars and locomotives may be limited. This would have an adverse effect on the quality of service provided to shippers, and in addition, could result in an increased demand for federal and state financial assistance as the deferral of investment leads to a deterioration of railroad infrastructure.

Poor track maintenance and failure to reinvest in track may also reduce travel speeds, and therefore increase transit times to the detriment of shipper service.

7. Will increasing the railroad's debt load affect its ability to remain financially viable during a downturn in the economy?

During recessions the demand for railroad freight services decreases. However, railroads are not as able as other industries to adjust their expenses when revenues decrease due to labor agreements and the large investment in fixed assets that are not transferable to other uses. Taking on increased fixed rate debt will exacerbate this problem. In the worst case states and shippers could again be faced with a situation like the early 1980s when many of the railroads serving the Midwest were in bankruptcy, or like the situation in the 1970's when seven northeast railroads went bankrupt and the Federal government created Conrail.

All of these impacts upon shippers would flow through the U.S. economy. General economic impacts of higher costs and problems with rail service may include increased inflation as higher transportation costs flow through to product prices, reduced employment in industries affected, decreased product competition from market closures, and a possible diminishment of the competitiveness of U.S. products in world markets.

WILL TAXPAYERS BE ASKED TO BE THE ULTIMATE "WHITE KNIGHTS"?

The ultimate issue in all of these railroad transactions is the essential nature of the transportation service these rail carriers provide. If it were not for this concern, the State of Iowa would not be testifying here today. If it did not matter to our economy when railroads run out of money, defer track maintenance, fail to purchase equipment, reduce service, and abandon track, then we would not care if railroad leveraged buyout attempts proceed unregulated.

The fact is, however, that it does matter a great deal to our economy if our railroads are forced into financial stress. Congress and the states have shown just how much it matters by committing literally billions of dollars of public funds to Conrail and federal and state rail assistance programs over the last decade to preserve essential rail service.

If the leveraged buyout fever for railroads spreads, taxpayers may find that they will be called upon to be unwilling "white knights". Beyond the fact that taxpayers already pay for LBO's by subsidizing LBO interest expense, there will also be increasing demands upon government to spend taxpayer dollars to preserve rail service in the wake of railroad LBO's. We already foresee this in the Midwest as a result of the CNW buyout, as CNW indicates it will now have less money for branchline rehabilitation. Therefore, if branch lines are to be preserved we may see increased demands for public and shipper rehabilitation assistance.

Nationally, other forms of assistance more drastic may prove necessary if any leveraged buyouts result in major railroad bankruptcies such as preceded the formation of Conrail.

Will the taxpayers be willing to come up with the funds to preserve rail service when the need for funds may have been created by leveraged buyouts?

If they do provide funding, the public will pay a price that might otherwise have been avoided by timely regulatory review. If, on the other hand, the public balks at "bailing out" rail service under such conditions, substantial rail service may be lost. Under either scenario the nation will pay a very high price for any failure to act now.

LEVERAGED BUYOUTS:
THE NATURE OF THE TRANSACTION

In a leveraged buyout (LBO) a company is acquired in a transaction financed largely by borrowing. Later this debt is repaid with funds from the acquired company. These funds can be derived from cash reserves, the realization of new operating efficiencies, overfunded pension funds, deferral of capital expenditures, and from the liquidation of assets.

The first major LBO occurred in 1979 when Kohlberg, Kravis and Roberts (KKR) acquired Houdaille for $343 million. Since 1979 KKR has been the major investment banking firm specializing in this type of transaction, and it was this firm's recent hostile takeover of RJR Nabisco for $20.6 billion that raised concern in Congress over the adverse impact such transactions may have on the national economy.

During the early 1980s leveraged buyouts remained relatively small in value. In 1981, the top eight LBO deals combined involved only $2.3 billion. But beginning in 1984 deals began increasing in size at an accelerating pace. In 1984, there were 60 leveraged buyouts of public companies. In 1985, 241 LBOs were completed with a combined value of $18.4 billion. Last year the RJR Nabisco takeover alone exceeded the entire 1985 total.

Along with the increased popularity of LBOs there has occurred a significant restructuring of the capitalization of American firms. Fearing potential takeover, firms have been actively converting equity to debt. From 1983 through 1988 American corporations have doubled their debt to $1.8 trillion while retiring more than $400 billion of equity. During 1988 alone U.S. corporate debt increased by $207 billion while equity decreased by $140 billion.

Proponents of leveraged buyouts view this restructuring of American business as positive. They argue the replacement of equity with debt forces management to be more vigilant and responsive to the interests of stockholders. This may be true. On the other hand, taking on increased debt makes firms more at risk when the economy experiences a recession. And even in good times the risk of insolvency increases. In 1984, 51 large companies defaulted on $11 billion in debt. Last year, 87 companies defaulted on debt totaling $21.4 billion. Also, the share of corporate America's cash flow consumed to service debt has increased from an average of 17 percent during the 1970s to 25 percent last year. This reduces available cash flow for other purposes such as capital investment in plant and equipment, new job creation, and research and development.

In traditional business management new debt is incurred for such purposes as capital investment, expansions, and increased productivity--all of which return either new revenues or cost savings to the company which can be used to pay off the debt.

In most leveraged buyouts, however, the only thing purchased with the new debt is ownership and control of the corporation, which is turned over to the new buyers. There is therefore no new revenue to pay off the debt, and the company is immediately financially weakened. It is then up to the new owners to figure out ways to make cutbacks, reduce operations, and liquidate assets.

Historically, it has been necessary to improve the financial health and earning power of a company in order to make a profit. However, in a leveraged buyout it is not necessary for the company to be more financially healthy at the end of the buyout period than before the buyout.

Consider the example of the recent Japonica buyout offer for CNW Corporation. Before the buyout activity began, CNW shares were selling for approximately $29/share, a direct measurement of the financial health and earning power of the company. Yet, Japonica's proposed common stock equity investment of only $120 million would have turned over complete ownership of CNW to Japonica for less than $6.50/share of Japonica investment. (The remainder of Japonica's offer being financed by debt to be assumed by the company.) Therefore, for Japonica to make a profit it would have only needed to eventually sell out for more than its $6.50/share investment. Japonica could therefore have removed over 75% of the wealth and financial earning power from CNW (as reflected by the pre-buyout stock price of $29/share).

This type of transaction can thus allow corporate raiders to profit even though the company purchased may be left a shell of its former self. It is therefore of great concern that this type of activity is now spreading to the U.S. railroad industry, which provides basic transportation service to our economy.

RAILROAD DEBT LOADINGS THAT HAVE ALREADY OCCURRED

The loophole in ICC regulatory power over acquisitions of railroads and railroad holding companies to non-carriers has already contributed to defensive debt loadings of some of the major railroad holding companies:

1. Santa Fe Southern Pacific Corporation: In 1987 the Henley Group launched a hostile takeover attempt for the Santa Fe Southern Pacific Corporation, which at the time owned both the Santa Fe and Southern Pacific railroads. Because the Henley Group was a non-carrier, however, the ICC exercised [illegible] jurisdiction. As is often the case in buyout attempts, the hostile bidder was unsuccessful in obtaining control, but a high price was extracted from the company. To fend off the raid, SFP in January 1988 declared a one-time special dividend of $30 per share - $25 in cash and $5 in 16% interest debentures (often referred to as "junk" debt). The total payout was $4.68 billion, about $3.66 billion of it borrowed. Henley retreated from the now highly leveraged company.

   Fortunately SFP had numerous assets it could sell to help pay off the debt. Among these was the ICC-forced-divestiture of the Southern Pacific, to Denver & Rio Grande Industries for $1.02 billion. By year end 1988 the restructuring debt had been reduced to $1.4 billion.

2. Burlington Northern, Inc.: Burlington Northern, Inc. (BNI) is a holding company, not a railroad, but this is now a distinction without a difference -- as a result of a 1988 transaction its sole remaining major asset is the Burlington Northern Railroad

Company, the nation's largest railroad when measured in total route miles. Nevertheless, acquisition of BNI by a non-carrier would not currently come under ICC review and therefore BNI is potentially subject to unregulated takeover.

BNI had historically been not just a railroad but also a major natural resource company (oil, gas, timber). However, in a move that many analysts say was partially motivated by a need to make BNI less vulnerable to potential corporate raiders, in 1988 BNI spun off its natural resource holdings by forming a new corporation called Burlington Resources (BR). BNI placed all its natural resource holdings under the ownership of BR, sold 13% of the stock of BR to the general public to establish a market value, then distributed the remaining BR stock to all BNI shareholders essentially as a non-cash "dividend". This distribution of the assets had some tax advantages for shareholders but may have also hidden the true value of the impact on BNI. BR's stock has now more than doubled but the operational railroad has not received any of the benefits of this. If BNI had instead segregated its natural resource assets by auctioning them to the public in cash sales, the railroad would have been able to benefit from the proceeds of these sales.

A part of this transaction that has raised some objections was that the new natural resource company was spun off without taking with it the debt load that had been incurred by the natural resource operations. BR was created as an essentially debt-free company, leaving over $2.5 billion of debt incurred for natural resources purposes with BNI. Because BNI is now essentially comprised of just the Burlington Northern Railroad, the railroad will now have the responsibility of paying off this debt, even though it was originally incurred for non-railroad activities. (BN Railroad's own debt at the time was only $1.3 billion.) The new BR Corporation assumed some of the responsibility for expected dividend payments thereby reducing

BNI's expected dividend payment. This somewhat balances the debt-loading impact, however, the nature of the payment duties is not the same. If times are bad, BR can choose not to declare a dividend payment, but BNI cannot choose to forego debt payments.

The end result is a railroad holding company, with essentially no natural resource wealth remaining, that is much more leveraged than before — over 56% of capitalization. While BNI is now seemingly less vulnerable to a takeover, impacts of the heavy debt load on transportation may be felt in a recession as BN Railroad's cash flow is now effectively highly committed to debt payments.

3. CNW Corporation: The leveraged buyout activity for CNW Corporation in late 1987 by Management/Gibbons, Green van Amerongen, Ltd. plus the recent Japonica Partners, L.P. hostile takeover attempt (which was countered by a successful defensive Blackstone / Management / UP Railroad bid) is the clearest example to date of the potential impact on transportation of railroad buyout activity.

Where both the SFP and the BN transactions also involved substantial non-rail holdings, the CNW Corporation is basically just a railroad holding corporation. In late 1987 when CNW management and Gibbons, Green van Amerongen proposed to acquire CNW Corporation, the corporation's only substantial non-railroad asset was Douglas Dynamics, Inc., a snow-plow manufacturer, which comprised less than 6% of CNW Corporation total assets. With the sale of Douglas Dynamics in 1988, CNW Corporation is now a company specializing only in railroading. CNW Corporation owns two railroad operations: Chicago Northwestern Transportation Company and Western Rail Properties, Inc. (WRPI), which although owned as separate legal entities function cooperatively as one operating railroad.

The intensity of shipper, state and Congressional concerns about leveraged buyout activity for CNW Corporation has appropriately been far greater than for previous railroad holding company transactions, because any effects of a CNW leveraged buyout will necessarily impact directly upon the corporation's railroads. Nevertheless, the ICC concluded in its recent evaluation of the Japonica bid that because Japonica is a "non-carrier", the Commission had questionable jurisdiction over such activity.

A brief review of the three known bids which were offered for CNW Corporation indicates why Congressional concern about leveraged buyouts of railroad holding companies has been so great:

- The 1987 attempt by CNW Management and Gibbons, Green van Amerongen, Ltd. would have added $473 million in new debt without adding any new operating revenues, cost-saving agreements or assets, thus greatly weakening the company. The proponents of that transaction indicated that the debt would be retired through a sale of numerous rail lines. After opposition by several midwestern states and institutional shareholders, and uncertainty over line sales caused by the Pittsburgh & Lake Erie court decision, the buyout offer was withdrawn.

- The recent Japonica Partners, L.P. offer would have more than doubled CNW's debt by adding $615 million in new debt. The new debt would have required approximately $112 million per year in principal and interest payments, even though CNW's 1988 total available cash flow available for capital spending, dividends, and cash reserves was only $95 million. Several states, shippers, and labor organizations expressed grave concern that the resultant financial weakening of CNW would have resulted in greatly reduced capital reinvestment, deferred maintenance and increased abandonments. At Congressional request, the ICC reviewed the proposal and concluded that the buyout might make CNW vulnerable to cessation of service in the event of any combination of a recession, grain market decline, or logjam in the formation (divestiture) of short-line operations. Japonica withdrew its offer after the CNW Board accepted a higher defensive offer from Blackstone / Management / UP Railroad.

- The current Blackstone / Management / UP Railroad offer, although possibly less damaging than the Japonica offer, will nevertheless financially burden CNW. It will add approximately $678 million net new debt to CNW, according to recently-filed SEC documents on the transaction.

Although the cash flow drain for the new debt will be balanced somewhat by new agreements with UP Railroad and proposed cost-saving measures by management, it is expected as is typical with LBO's that the restructured CNW Corporation will need to reduce its capital investments compared to pre-buyout plans for the company. With the transaction's requirement that capital spending be concentrated on CNW's east-west main line, this would necessarily result in reduced capital spending on branch lines. The State of Iowa is concerned that the long-term impacts of this anticipated reduction of branch line investment may include less frequent service, deferred maintenance, line sales, increased abandonments, and demands upon state and federal rail assistance programs to help preserve branchline service. It is also not clear what impacts may be felt upon shipper service from projected layoffs of CNW white collar and management personnel. There may also be "ripple effects" upon other railroads that connect with UP (including some financially marginal railroads that cannot afford to lose significant traffic) if UP diverts traffic from these other railroads to CNW.

Perhaps the best indication of the impact upon transportation of the proposed CNW buyout is that this course was not the first choice of CNW management as the best way to run a railroad. Before the Japonica offer, CNW management had laid out a business plan emphasizing improvements in rail service, increased capital investments, and reduced debt loads. All of this has now changed as a result of the buyout, and the Blackstone / Management / UP bid was simply the best that could be done under current law which allows buyout transactions to move forward with no ICC jurisdiction over public interest impacts.

It is clear from a review of these three transactions that the current "ICC legal loophole" environment which leaves railroads open to unregulated leveraged buyouts has left few tools available to railroad corporation managers other than those which have the unfortunate effect of financially weakening their companies. It would be far better for U.S. transportation if another type of defense were available -- a defense of national, shipper and public interests through the intervention of ICC regulatory authority to block new debt loadings upon railroads which could jeopardize transportation service. In this type of environment railroad managers could still work to enhance shareholder value in prudent ways, as a "going concern", without the threat of catastrophic changes in financial structuring that the LBO environment now imposes.

POTENTIAL FUTURE TARGETS

Was the CNW leveraged buyout an isolated event, or can more such attempts be expected? If leveraged buyouts spread throughout the U.S. rail industry, what might this portend for the financial stability of our rail system and the public interest? How will this affect U.S. transportation efforts, which have strived at great public cost over the last decade to help achieve railroad financial stability?

Now that Japonica Partners, L.P. has successfully proven through its CNW bid that there is a profit to be made in leveraged buyout attempts on railroads (even if unsuccessful in taking control), the question arises as to which other railroads may be future targets.

Investment Community Anticipates Further Railroad Takeovers

It is highly noteworthy that the investment community has already begun publishing analyses of which railroads might be potential targets of future leveraged buyout attempts. Attached to this testimony as Appendix 2, is a recent investment analysis report from Dean Witter which gives that firm's opinion of which railroad holding companies are vulnerable to leveraged buyouts. At least 6 Class I railroads beyond CNW are listed as vulnerable or "very vulnerable": Norfolk Southern, Conrail, Santa Fe, Burlington Northern, CSX, and Soo Line. The report notes "The real standouts are NSC (Norfolk Southern) and Conrail."

A May 14, 1989 article from the Washington Post noting the takeover prospects for Conrail are very high after the April 1, 1990 expiration of Congressionally imposed buyout restrictions substantiates the Dean Witter opinion. See Appendix 3.

Lessons from CNW Example

The current CNW case provides a useful example of what may happen if the loophole in ICC jurisdiction is not closed soon, and other railroads are allowed to become targets with no public interest criteria applied. The CNW example showed that even if corporate raiders do not succeed in taking control, defensive or "friendly" actions usually must also of necessity weaken the railroad company financially.

The CNW is a relatively small railroad, which was in part "rescued" by the giant Union Pacific Railroad acting as a "white knight" because of the unique interdependent relationship between these two railroads. Yet even in this uniquely favorable situation it was necessary to create a huge new debt load.

Will other railroads be so fortunate as CNW? Is there a "white knight" large enough or tied closely enough to such giants as Norfolk Southern, CSX or Conrail to rescue these railroads from the corporate raiders? If not, what scenarios might be played out if these railroads have to develop truly "stand-alone" defenses?

Potential Public Interest Impacts on Targets

Analyses by the investment community of potential corporate targets are based solely on the financial values (often predicated upon break-up) of the companies involved, with no consideration for possible public interest impacts of a takeover. It is worthwhile, however, to consider some of the potential public interest impacts if more of our nation's major railroads become takeover targets:

1. Norfolk Southern (NS)

This railroad is arguably the nation's strongest Class I railroad and hence is seen by the investment community as a "very vulnerable" target for takeover.

NS has used its strength in recent years to develop a new network of fast intermodal trains, making major investments in innovative equipment. This intermodal service is reducing congestion and wear and tear on the nation's highways and conserving energy supplies. What might be the impact if a leveraged buyout of NS caused NS to forego capital investments in new equipment?

NS has also been very innovative in working to lease, rather than demand cash sales, of low-density lines to new short lines. This has helped to preserve essential rail service on many lines. Would a highly leveraged, cash-poor NS take a similar approach, and if not what might this mean for abandonments of service?

NS has been described as a "no-frills" railroad, concentrating its attention on providing sound transportation service. If this description is accurate, where could major cuts be made to allow payment of new debt? These are just a few examples of public interest impacts on a major railroad providing a large portion of America's transportation service.

2. Conrail

It would be highly ironic if Conrail, the railroad corporation formed from the bankruptcies of seven northeast railroads and made financially sound with $7 billion of U.S. taxpayer funds, were now allowed to be thrown into financial instability because of a loophole in federal law. Just a few short years ago, the financial stability of Conrail was the major focus of the debate over whether to sell Conrail to the public or to Norfolk Southern Corporation or to auction it off in segments. It was clear from that debate that all parties concerned wished to assure that a privatized Conrail would continue to survive and prosper, after so much public money had been spent to achieve its stability.

Partly for these reasons, the U.S. Government accepted a sale price for Conrail which returned only $2 billion to the Treasury, so that Conrail might be privatized as a railroad with almost no debt and therefore be assured of the ability to reinvest in its physical plant and transportation service. If Congress and U.S. DOT had felt it was acceptable for Conrail to be highly leveraged, it would most likely have been possible for the taxpayers to have received a much higher sales price.

On April 1, 1990 the buyout restrictions which Congress imposed on Conrail will expire. Analysts are now saying that Conrail is a prime takeover candidate, precisely because Congress and U.S. DOT did such a good job of privatizing it as a viable, low-debt railroad. The profits from this financial viability -- created at great taxpayer expense -- may thus fall to the corporate raiders, and not to the taxpayers who made the sacrifice to sell Conrail for so little.

3. Santa Fe

It seems somewhat unusual that Santa Fe Pacific Corporation is now listed as a potential takeover candidate, after having already fought off the hostile Henley takeover attempt in 1987 by incurring a $3.7 billion debt load. However, SFP was successful in selling off assets to reduce the new debt load, so that by the end of 1988 it had been reduced to $1.4 billion.

It appears that now that SFP is emerging once more into financial health it is therefore once again a takeover target. This seems to indicate that in the current unregulated takeover environment, it is necessary to always maintain a state of high leveraging and financial insecurity.

This is not the best environment for our railroads to function within to provide sound transportation service for our nation's economy.

4. Burlington Northern

The same comment regarding Santa Fe also applies to Burlington Northern: it seems unusual now that BN should be listed as a takeover target. Burlington Northern is now already highly leveraged as a result of its Burlington Resources spin-off. After the natural resources debt is repaid, will BN need to go through another large debt payout, for a leveraged buyout?

BN is our nation's largest railroad, hauling major portions of America's coal, grain and merchandise. BN has traditionally been a leader in innovations in the U.S. railroad industry, and has shown a willingness to invest in projects with long-term returns such as concrete ties, research on coal-fired locomotives, and innovations in new equipment.

If BN, NS, and the other railroads that have functioned as the industry's leaders become so financially strapped that they must abandon their ability to invest with a long-term perspective, it will harm the nation's rail industry. We are concerned that there will be no one to step in to fill the void to fund railroad research and innovation.

5. CSX

CSX Corporation is a major transportation provider. The Corporation owns CSX Transportation (the railroad), Sea-Land Corporation (a container-ship company) CSX/Sea-Land Intermodal (coordinator and marketer of intermodal services), and American Commercial Barge Lines (one of the nation's largest barge lines).

CSX has already spent about $1.3 billion, mostly financed from borrowing, to reacquire 40 million shares of its stock. According to industry analysts this treasury stock acquisition was undertaken primarily because of the company's fear of takeover.

Even with the recent stock repurchase, however, CSX is still not a highly-leveraged company, with long-term debt totaling only 34.8% of total capitalization. This is one reason analysts list CSX as a potential takeover candidate.

CSX is one of the nation's six major Class I railroads. Therefore, any takeover attempt of this company could have far-reaching impacts on transportation due to the major importance of CSX to the eastern half of the U.S.

6. Soo Line:

Earlier this year the Canadian Pacific Corporation (CP), which owns 56% of Soo Line's stock, announced that it intended to sell its Soo Line stock. However, after receiving bids, CP decided to hold onto its Soo stock at present, and work to improve its value. The currently pending sale of Soo's Kansas City to Chicago main line to Rio Grande Industries is part of CP's efforts to improve Soo's value.

Soo Line is a significant "Granger" railroad in the Midwest with a number of light-density grain gathering lines. With its 1987 sale of over 2,000 miles of its system to Wisconsin Central Railroad, today's Soo Line is mostly now comprised of the lines of the old Milwaukee Railroad, which Soo purchased in 1985.

Soo Line is listed by analysts as "vulnerable" to a takeover, but a takeover at present is questionable because "the value isn't there". If CP works to improve Soo's value Soo may be a target in the future, however, especially considering CP's already-expressed desire to sell its stake in Soo.

Midwest states are concerned about the prospect of a leveraged buyout of Soo Line, for much the same reasons as in the case of the CNW buyout. Both CNW and Soo are highly dependent upon grain traffic, which is inherently cyclical and is also affected by unpredictable events such as droughts. As noted by the ICC in its analysis of the Japonica CNW offer, a recession can easily occur simultaneously with a downturn in grain traffic. While a financially viable railroad can withstand such a combination of events, a highly leveraged railroad, as ICC noted, could suffer a cessation of service.

These same rail lines have already been through one bankruptcy with the Milwaukee Railroad. The public had hoped that Soo Line's acquisition of Milwaukee would bring financial stability for this system. We now feel this stability could once again be jeopardized if Soo becomes a leveraged buyout target.

BACKGROUND
ON NEED FOR ICC REGULATION OF RAILROAD HOLDING COMPANIES AND NON-CARRIER BUYOUTS

1. Railroad Holding Companies: Are They or Are They Not Regulated by ICC?

Since the emergence of railroad holding companies in the late 1960's and early 1970's the ICC has held conflicting opinions at various points in time regarding its jurisdiction over non-carrier holding companies. It is easy therefore, to see why ICC Chairman Gradison's letter to the Honorable Senator James J. Exon at the conclusion of Ex Parte 480 in May of this year, came to no definitive conclusion on the Commission's jurisdiction over Japonica's proposed LBO or the ability of CNW to service the increased debt without deterioration of service and asset dispersal. In its report to Senator Exon the Commission conceded "Our preliminary analysis...suggests, however, that establishing the commission's jurisdiction to oversee or approve Japonica's proposed transaction and related financing under established precedent may be difficult as a matter of law." Indeed, there were three separate, but different, dissenting opinions from the report regarding jurisdiction. Two of these stated that the Commission had jurisdiction and the third stated that "...I am reluctant to dismiss our jurisdiction over this matter."

2. Previous Legislative Recommendations

Although the current LBO environment is creating extreme impacts from this lack of clear-cut ICC regulatory power, the issue of ICC regulatory authority over railroad holding companies is not a new concern.

The ICC has called upon Congress numerous times for remedial legislation to cope with rapid changes taking place in the railroad industry, which the ICC viewed as designed to escape regulation.

The ICC recommended remedial legislation to Congress as early as 1971, and again in 1973, 1975, and finally in 1977 with its publication of a report which Congress had specifically requested on the issue.

3. The ICC Report on Railroad Conglomerates

In 1976 Congress directed the ICC to examine conglomerate and other corporate structures in the railroad industry in the framework of a revised national transportation policy toward railroads in the public interest. Congress was concerned about whether the then present corporate organization of the railroad industry was compatible or conflicted with national policy. The ICC determined in Ex Parte 323 (1976) that diversified holding companies were the principal organizational form of the railroad industry at the time and that corporate practices involved numerous intercompany transactions, and the holding company was therefore in a position to set the terms and conditions of such transactions, *including those of its carrier subsidiaries*. Emphasis added.

In its report to Congress as Directed by Section 903 of the Railroad Revitalization and Regulatory Reform Act of 1976, *Railroad Conglomerates and Other Corporate Structures* (1977), the ICC stated in its Ultimate Conclusions and Recommendations, beginning on page 73 of the Report, in pertinent part said: "*We are convinced by this history that the scope of our regulatory authority must be extended to require that our prior approval be obtained as a prerequisite to the acquisition of control by any person over a major railroad.*" Emphasis added. Later in the Conclusion the ICC said; "Accordingly, we urge prompt passage of legislation which would require our prior approval of the acquisition of control over any class I railroad as defined by the Commission." Emphasis added.

The report included a review of earlier efforts to obtain clear jurisdiction over non-regulated holding companies (non-carriers) in part as follows:

> 'The rapid growth of the parent holding company structure within the railroad industry has prompted the Commission to submit to Congress legislative changes designed to cope with certain practices which are viewed as a threat to the financial strength and public responsiveness of the rail components of such structures.'
>
> 'Most recently the Commission on September 12, 1975, submitted to Congress a bill that would subject the acquisition of railroads and other regulated carriers by holding companies to Commission review, and approval would be required in the case of intercompany transactions involving the carrier and other members of the holding company group. The bill was introduced on October 2, 1975, as S.2455. No Congressional action was taken that session.'
>
> 'Specifically, S.2455 would among other things require a person which is not a carrier, or two or more such persons acting jointly, to obtain Commission approval before acquiring control of a carrier, whether by stock ownership or otherwise. Any such person authorized to acquire control of a carrier, or found to be in control of a carrier, to the extent provided by the Commission, would be considered a carrier under those provisions of the ICA pertaining to reports, accounts, security issues, and assumptions of liability, including the penalties applicable in the case of violations of such provisions."

The ICC's ultimate Conclusions and Recommendations in Conglomerates are attached as Appendix 4.

Admittedly, the ICC's concerns at that time were about holding company abuses of the fiduciary and financial aspects of intra and inter corporate transactions - not LBO's. However, the ICC had insight and wanted enabling legislation to protect common carriers from corporate practices which were harmful and would diminish railroads' ability to function in the public interest. Those concerns included payment of holding company administrative expenses, excessive or unearned dividends, use of subsidiary assets for protection of holding company management, use of carrier's credit, cash management, artificial prices for sales/purchases of materials, supplies and services, etc.
In comparison to the current practices prevalent with the newly-invented LBO method of buyout, these previous concerns cited by the ICC appear almost minor. If one applies the same public interest criteria for preservation of rail service as a "going concern" that the ICC applied in its historical concerns, it is clear that current LBO transactions would be classified as potentially one of the most highly abusive forms of transaction to threaten the financial viability of railroads.

FEATURES OF REMEDIAL LEGISLATION NEEDED NOW

I wish to conclude my testimony by urging this Committee to take immediate action to pass remedial legislation to give the ICC full regulatory authority over the acquisition of control of railroad carriers and railroad holding companies by non-carriers.

There are a number of bills that have already been introduced to address this issue. Rather than address each of the specific bills, I will simply address the features which Iowa DOT feels must be included in any bill to address this issue:

1. Effective Date. It is absolutely crucial that action be taken by Congress immediately to address this issue. The CNW is already in play, and Wall Street is already speculating on who is next. Reports we have received from investment houses indicate that Norfolk Southern stock is now highly active. Conrail becomes available next April 1.

   We recommend legislation have an immediate effective date upon introduction. Action should be taken to enact a bill this Session, hopefully before summer's end.

2. Holding Companies. Given the history of confusion over ICC regulatory authority over holding companies, the bill needs to specifically require ICC approval of the acquisition of control not only of railroads but also of entities which own or control railroads. None of the bills we have seen presently include this important provision needed to clear up this issue.

3. Public Interest Criteria. The bill should establish certain public interest criteria for ICC approval similar to the criteria used by the ICC for acquisition by railroads or railroad holding companies. It should require ICC denial of any transaction which could:

   - Potentially harm rail service or the railroad's ability to reinvest in rail service; or

   - Potentially jeopardize the railroad's ability to reliably provide transportation service in economic or traffic downtowns; or

   - Potentially jeopardize any U.S. Government or state government securities with the railroad.

4. Public Involvement. The bill should assure a publicly open ICC review process similar to the criteria used by the ICC for acquisition by railroads or railroad holding companies which should include at a minimum:

   - Notification of state governments in the service area of the affected carrier(s).

   - Open public access to all documents submitted in the proceeding.

   - Opportunity for states to submit comments and positions and to request protective conditions.

5. Protective Conditions. The bill should give the ICC the power to set protective conditions on any transaction as a condition of approval.

6. Speed of Review. It would be acceptable for the bill to require a relatively swift ICC review of the transaction. Our purpose is to submit proposals to public scrutiny and conditions--not to mire them in a bureaucratic process so lengthy that its mere length may prohibit any transaction. However, we suggest no timetable be set less than 90 days, as at least this much time is required to adequately review any transaction of such major scope and public impacts.

CONCLUSION

Leveraged buyouts (LBO's) of railroads and railroad holding companies pose a highly significant threat to the future of U.S. rail transportation.

If ICC regulatory authority is not established very soon for these transactions, all the other efforts over the last 15 years on the part of Congress, the ICC, and the states to improve the financial stability of our railroad system may prove futile. That financial stability may be destroyed in the course of the next few short months or years, once the LBO raiders set their sights on our railroads.

The State of Iowa urges immediate Congressional action to address this clear and present danger to the viability of our rail transportation system.

Senator EXON. Mr. Rensink, thank you very much. I have two or three questions then I would be glad to recognize Senator Pressler, who I am sure will ask some questions of this panel since he is an active sponsor of the measure that we are considering today.

I will start with you, Mr. Kennedy. Do you have an opinion on the merits of S. 1005, the Harkin-Pressler bill, as compared with the provisions of the related measure on the House side introduced by Congressman Dingell, as I understand it?

Mr. KENNEDY. There are features that have already been spoken about. The fact that S. 1005 contains employee protection and the House version leaves that to the discretion of the Interstate Commerce Commission. In that respect we find this legislation superior from our point of view. We stand by our fact that we think both legislations in our opinion need to be more specific for the reasons I went into in my direct testimony.

By the way, Mr. Chairman, I neglected to introduce the gentlemen who are accompanying me. The gentleman on my left has been before this Committee a couple of hundred times—Mr. William Mahoney—and the gentleman on my right, John O'Brien Clark. Not only did I bring my lawyer on my left, but my lawyer's lawyer on my right. So I am prepared for each ear to be whispered into.

Senator EXON. With those scary introductions, I have no further questions.

Mr. Rensink, I assume that you were here to hear the ICC testimony.

Mr. RENSINK. Mr. Chairman, Mr. Holland, who is to my right, who is director of our rail division for the Iowa Department of Transportation, was in attendance. I caught an airplane early that morning to try to get here on time and I met all the blue suits coming out of the door so I just missed the testimony, so I did not hear that testimony that day.

Senator EXON. Well, let me just fill you in on a little bit of it to see if you could respond for the record and please feel free to have a brief consultation with those whom you brought with you who did hear it.

The ICC testimony states, "Because debt is cheaper than other forms of new capital, discouraging its acquisition at reasonable levels may not be sound transportation policy.

The ICC also suggested that we might have more revenue-adequate railroads by increasing the relative percentage of debt financing.

Do you have a response or an opinion to this ICC position, especially as it regards S. 1005?

Mr. Rensink. Well, as was earlier stated this afternoon in earlier testimony, that incurring additional debt is not necessarily wrong in itself. We are not necessarily opposed to railroads incurring debt. I think the bottom line is the matter for which this debt is being incurred and how it is going to be used.

In the Japonica situation as it pertained to CNW, it was our opinion and our understanding that the $600 plus million of additional debt that that particular transaction would have brought about would have been solely for the stock purchase, if you will, and that none of that additional debt would have been directed towards an increase or an improvement in the facility and the maintenance, and people, or those other things that are so necessary to make a rail line viable and to provide the very critical public service to the citizens of our state and throughout this country.

So I guess our position would be, it is the manner in which the debt is used and for what purpose it was spent.

Senator Exon. What is your reaction to those who say that the increased debt associated with the leveraged buyouts forces management to be more efficient and that passage of S. 1005 would merely serve to insulate existing management from the threat of potential takeovers?

Mr. Rensink. Mr. Chairman, certainly more debt demands and requires people to become more efficient. We find that in our own personal lives and in other business dealings, but the pie is just so big. There is just so many dollars that are generated from an operation and from an enterprise, and when those dollars and the pieces of that pie and a greater portion needs to be spent for coverage of debt, then some other piece will be diminished, and it does force us to a great degree to be more efficient in other areas that we cannot afford to be more efficient in.

Senator Exon. Thank you very much. We will pause for just a moment. I know Senator Pressler has some questions. He had to step in the back to take a telephone call. He will be right back out. Pending his return I would just invite you, Mr. Rensink, or you, Mr. Kennedy, or any of the other individuals at the table to make any statement that you would like to make at this time for clarification of any of the points that have been brought up, and then I will recognize Senator Pressler.

Mr. Kennedy. First of all, I would like to very briefly say that everything that Mr. Rensink said in his summary of his statement we agree with, and we also agree totally with his responses to the questions that you have presented to him without any deviation.

And also there is a document that I have here that we did not have available when we prepared our testimony. It was just sent by the ICC to us on June 21st. We received it today.

It is a copy of the Interstate Commerce Commission decision in Finance Docket 30911. It is the Chicago, Missouri and Western Railway Company exemption, acquisition, and operation of Illinois Central-Gulf Railway Company, which is the same decision that we referred to in our prepared testimony, but we think that it would be useful for the committee to have a copy of that. So, if there is no objection, we would like to have it submitted for the record.

Senator **Exon**. Without objection, we would be very pleased to receive that, and we will accept it for our files.

Mr. **Kennedy**. If I might, Mr. Chairman, there is one paragraph in particular that I would like to call attention to in Mr. Lamboley's dissent, a brief paragraph which says:

> For instance, the trustee recites that while the amount of the original loan for the purchase of CNW was $86,650,000, Vanango made a capital contribution to the CNW of only $55,000 with subsequent loans the amount of indebtedness rose to $100 million principal and in August 1988 with interest expense included amounted to $107 million. Only one payment of principal in the amount of $35,000 was made, and there were no payments of interest. This highly leveraged arrangement reflects an indebtedness which is a concern for this as well as other LBO transactions in the rail industry, and this is one in which the commission had jurisdiction and refused to look at the finance.

That is the purpose of our offering that for the record.

Senator **Exon**. Thank you, Mr. Kennedy. Thank you for pointing that out.

Senator Pressler.

Senator **Pressler**. Yes, I have one specific question, but a philosophical question. How do Congress and the public agencies deal with this new situation we are in with these LBOs and takeovers? It used to be that we would have the actual president of the company sitting here, and we could grab ahold of him and ask him questions, and we still have the president of the company, but usually he is reporting two or three layers up to the real owners. That presents a new challenge in public administration or regulation of protecting the public interest, and I hate to get back into big regulation and so forth.

Are we in a new era of protecting the public interest when it comes to railroads?

Mr. **Kennedy**. Yes, I could not agree with you more, Senator. It is a refreshing new era. I might say not the situation that causes it, but I think the recognition that it is a new era and that the Congress of the United States should do something about it.

Senator Exon spoke before of the Eastern Airlines situation, and you and Senator Harkin have begun a process to address the problems that we faced in the railroad industry. And so one of the things we do is to enact legislation along the lines of S. 1005. We would submit with the modest improvements we think we offer to it, but we think that is a great step in the right direction.

Senator **Pressler**. How does yesterday's Pittsburgh and Lake Erie decision impact the implied labor production provisions of S. 1005?

Mr. **Kennedy**. It does not, Senator. If you would care for some elaboration, I would call on either my left ear or my right ear.

Senator **Pressler**. Let us hear from one of them.

Mr. **Clark**. The protection that is given through S. 1005 through 11347 is basically what is known as minimum standards legislation. That is the floor that the Congress considers to be necessary in the public interest.

The Pittsburgh and Lake Erie deals solely with the question of whether or not rail labor has a right under the Railway Labor Act to negotiation for protection that it considers to be necessary to protect its members, the employees.

Now, many times the 11347 protection matches with what rail labor considers to be necessary. In the past, though, it turned out that in fact in the past the rail labor organizations considered the commission's administration of what used to be 11347 and 52(f) under the Interstate Commerce Act did not meet the minimum public interest or the needs of the employees and they negotiated their own.

So, the way in which S. 1005 would work in the holding-type companies, it would require the commission to impose a minimum standard New York Dock as the level and then if rail labor considered it necessary to obtain more, they could negotiate with the railroad for a different type of protection.

And I might just add one of the comments that was made earlier in the testimony, the New York Dock protection does not guarantee employee six years' protection or whatever it is for no matter what. There is a cause-and-effect relationship. He has to be affected as a result of the transaction before the employee is entitled to any benefits under that protection.

So, if the transaction and control does not affect the employee, the fact that the employee subsequently loses his job does not mean he is entitled to benefits. It is there in case the control does something that effectively undermines the employee's livelihood.

Senator **Pressler**. Thank you very much. I may have some additional questions for the record. I want to thank these witnesses for their excellent testimony.

Senator **Exon**. Thank you, Senator Pressler, Mr. Kennedy, and Mr. Rensink. We thank you again for coming, and your actual testimony and you are excused.

We will now go to the third panel of the day, and I would like to have these gentlemen please come forth to the witness stand, Mr. John Swartz, Vice Chairman, Sante Fe Pacific Corporation, Mr. James Voytko, the Director of Research and Transportation Analyst for Paine Webber, and Mr. James A. Runde, Managing Director, Morgan Stanley & Company.

Gentlemen, welcome to you. We appreciate your patience. As you undoubtedly heard, we have accepted in full your statements for the record, and I would ask that you please summarize at this time, and we will start with you, Mr. Swartz. We are pleased to recognize you.

STATEMENT OF JOHN SWARTZ, VICE CHAIRMAN, SANTA FE PACIFIC CORPORATION; ACCOMPANIED BY JEROME DONOHOE, GENERAL COUNSEL

Mr. **Swartz**. Thank you, Mr. Chairman. It is a privilege to be here. I come, I think, with some trepidation because I remember Senate hearings back from my law school days here when I used to come down and sit in on them and thinking of Senators as being somewhat old and considerably wise. I have not been before Senate hearings of this type with any frequency since those days, and it is surprising how much younger Senators have become since I was a law school student.

Senator EXON. If you continue on that line, you can take all afternoon.

Mr. SWARTZ. I am John Swartz. As of the first of this month, I am no longer President of the Atchison, Topeka and Santa Fe. I have passed on that responsibility to a new fellow. I am still a member of the Atchison, Topeka and Santa Fe. The holding company, which is Santa Fe Pacific, and I am Vice Chairman of Santa Fe Pacific up until next January 1. For the last four or five years I have been President of the railroad, which, as you know, Senator, runs 19 miles up to Superior, Nebraska.

I have with me today our general counsel of the holding company, Jerome Donohoe.

I was going to point out before Senator Pressler left the room that he is from Yankton, so we have tried to cover all bases here.

Senator EXON. Well, to clarify the matter even further, Mr. Donohoe will know where I was born and raised, Lake Andes, South Dakota, 75 miles upriver, so we are all in this together.

Mr. SWARTZ. I guess the second reason I came with some trepidation is I felt perhaps I was an unusual witness for a hearing of this kind.

Santa Fe is not directly involved in the type of situation currently that raised the bill that is before you, and the one that is before the House.

We have, however, within the last year and a half been the subject of a threatened leveraged buyout.

There was a time not too long ago when the Henley Group and Michael Dingman were buying our stock and we were being spread all over the Wall Street Journal as threatened with a buyout.

I would have to be quite honest with you, sir, and say at that time it occurred to the management of Santa Fe Pacific that it might not be a bad idea to come to Washington and talk to our friends in Congress or to go to the Commission and make some inquiry as to whether or not the government should not be more involved in Mr. Dingman and the Henley Corporation's intent as to the Santa Fe Southern Pacific.

On further thought and after talking with our banker advisors and internal economic advisors, we decided that was not a good idea, and the basic reason I am here is to tell you why we did not think it was a good idea in our case.

First of all, as to the bill before you, we can find no evidence that there has been a problem with leveraged buyouts by non-rail owners. We cannot find too many cases where there have been such leveraged buyouts by non-rail owners of Class I railroads. One in fairly recent time was the Blackstone Group which bought a series of railroads that were owned by the U.S. Steel companies. To my knowledge, that has not been presenting any problem for those railroads.

I think there might be some in the industry that follow us, the financial and trade press, who would indicate that those railroads have actually improved.

Another one that preceded that by a couple of years was when Philip Anschutz bought out the Denver and Rio Grande. Now, he did not own a railroad at that time, and he bought—if I follow the record correctly—with almost 100 percent debt. I again think that the shippers that are served by the Denver and Rio Grande, the politicians in that general area served by the Denver and Rio Grande, and the employees would tell you that that has been a generally good thing for the Denver and Rio Grande.

In fact, he followed up that purchase, as you well know, when we had to divest of the Southern Pacific Transportation Company, in acquiring that property as well. And again, he leveraged that purchase I think by 100 percent. His advisor, banking advisor is here, and he could tell you more about the details, but it was heavily levered and it was supported by shippers, by the political groups in those states, and by the RLEA, and Mr. Kennedy, as a matter of fact. So far, at least, we cannot find evidence that these leveraged buyouts either by railroad entities or non-railroad entities of Class I railroads have presented any great problems.

And I guess it kind of goes back to the adage that I learned growing up in Kansas that if it ain't broke, don't fix it.

The second point why we think it would be not good legislation, particularly at the present time, and as alluded to by the prior witness, is that the ICC really is not staffed to make very sophisticated financial or economic determinations.

I can tell you that when we had to sell off the Southern Pacific Transportation Company, we went individually to the Commissioners to see if there were any kind of ground rules under which we had to sell.

We were concerned that we would end up making a deal that would not be acceptable to the Commission, and so we wanted to know if there were problems.

We asked specifically if leverage of the buyer would be a problem and the commissioners individually said to us quite frankly we do not—we are not bankers, we are not economists and since deregulation so much of our ICC economic staff is gone, we just do not have the sophistication or the staff to make those determinations; so that we will look at your potential buyers, but we probably will not go into the finance area.

I think the third point I would like to make is that the real answer if you worry about the railroad industry and what is going to happen to it is our rate of return. And one of the things that has happened, and it has again been alluded to, is that rates of return have slowly edged up under deregulation.

I think the lesson from that is we found that the less regulation we have on the railroad industry that is not needed, the better off we are, and the better off the shipping community will be.

Lastly, and I think it will be a point that is made probably in greater detail and more eloquently than I can make it, by the two bankers on this panel is that we are really afraid that the legislation of this type will have an adverse effect on the existing rail equities.

Anytime you take a buyer or potential buyer out of the market, you upset the supply and demand equation, and there is a group of people out there that is presumed to be a buyer of rail equities.

In effect, that has had an upward effect on rail stocks, and I represent some 158 million shares of Santa Fe Pacific stock and a lot of stockholders out there; we would hate to have to see the market for our shares depressed by taking a buyer out of the market. And, as I say, I think the bankers will address that issue.

I see my red light is on and I thank you very much, Senator.

[The statement and questions and answers follow:]

Statement of
W. John Swartz, Vice Chairman
Santa Fe Pacific Corporation
in Hearings on S. 1005
Before the
Subcommittee on Surface Transportation
Committee on Commerce, Science and Transportation
U.S. Senate

June 22, 1989

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the views of Santa Fe Pacific Corporation ("Santa Fe") on S. 1005. My name is W. John Swartz. I am Vice Chairman of the Board of Santa Fe, and a member of the board of directors of Santa Fe's wholly-owned subsidiary The Atchison, Topeka and Santa Fe Railway Company ("Santa Fe Railway"). Until May 31, 1989, I also held the position of President of Santa Fe Railway. I have been employed by Santa Fe Railway or its parent for 28 years.

By way of background, Santa Fe is a holding company with operating company subsidiaries engaged in real estate, natural resources, and transportation. In 1988, total Santa Fe revenues were $3.1 billion, and operating income was $631 million. Of this, Santa Fe Railway revenues of $2.1 billion comprised over two-thirds of total Santa Fe revenues, while Santa Fe Railway operating income of $219 million comprised slightly over one-third of total Santa Fe operating income. Santa Fe Railway is a Class I railroad carrier which operates over 11,000 miles of rail lines in 12 western and midwestern states, and employs over 20,000 people. Santa Fe Railway's principal routes include the corridor between Chicago and Los Angeles and other West Coast points, and between Chicago and the Gulf Coast. Santa Fe Railway faces intense competition for freight traffic from other railroads and motor, water, air and pipeline carriers.

Santa Fe opposes S. 1005 and similar legislation now being considered by the House of Representatives. These proposals would amend the Interstate Commerce Act by requiring Interstate Commerce Commission ("ICC") approval of acquisitions of control of Class I railroads by non-carriers. Under current law, ICC approval of such transactions is not required unless the non-carrier acquiring control is itself in control of another carrier.

The stated rationale and purpose of S. 1005 and its counterparts in the House of Representatives is certainly a laudable one--to ensure that the vitality of the nation's railroads is not impaired. However, Santa Fe's opposition to these bills is founded upon our belief that their passage would increase railroads' cost of equity and add unnecessary regulation, adversely affecting all railroads in general, and Santa Fe Railway in particular.

Like every other Class I railroad, Santa Fe Railway must make substantial capital investments in its plant and equipment in order to remain competitive. In 1988 alone, Santa Fe Railway made capital expenditures of nearly $273 million, and in the three-year period 1986-1988, total Santa Fe Railway capital expenditures were nearly $857 million.

The ultimate effect of S. 1005 and similar House bills, if passed, would be to increase the cost of equity, thus making it more difficult for railroads to raise the needed capital funds in the financial markets. Under current law, a non-carrier financial buyer could obtain control of a railroad-related company, with or without leverage, without ICC approval. I believe the presence of these return-oriented financial buyers causes railroad management to continue to focus on enhancing shareholder value, thereby minimizing the potential gap between intrinsic and market value. The absence of such buyers could eliminate this discipline, thus putting downward pressure on stock prices and, in turn, increasing the cost of equity.

By amending 49 U.S.C.§11343 to include a non-carrier's acquisition of control of a Class I carrier as one of the transactions for which ICC approval is required, the proposal would discourage such financial buyers for two reasons. First, ICC proceedings to approve the transaction could take up to 9 months, under the time limits prescribed in 49 U.S.C. §11345 (c) and (d). Second, under 49 U.S.C. §11347, the ICC would be required to impose extremely expensive labor protective conditions upon its approval of the transaction. There have been relatively recent purchases of Class I railroads (the purchases of the DRGW by The Anschutz Corporation and of seven midwestern and Pennsylvania railroads by Transtar, Inc., for example) which many rail industry analysts consider to be generally positive and which may not have gone ahead if this legislation had been in place.

Apart from the downward pressure that S. 1005 and its House counterparts would place upon railroad stocks in general, these bills are unnecessary to accomplish their intended purpose. Under existing law, the ICC has full and complete jurisdiction to approve, condition, and otherwise regulate in the public interest the sales or other transfers of railroad lines (49 U.S.C. §10901), and the abandonment of railroad lines (49 U.S.C. §10903). Moreover, the ICC today has extensive authority over a carrier's issuance of debt securities, including the assumption of debt (49 U.S.C. §11361 et seq.). Thus, to the extent the perceived problem of unregulated acquisitions of control of carriers by non-carriers is that such transactions may result in line sales, abandonments, and/or the creation of excessive carrier debt through the issuance of securities, the ICC has ample jurisdiction already. S. 1005 is therefore an unnecessary expansion of regulation.

The acknowledged impetus for S. 1005 and its House counterparts was the proposed leveraged buy-out of Chicago and North Western Transportation Company ("CNW") by Japonica Partners. That transaction, however, is not going to occur. CNW will instead be acquired by a different group of investors, including CNW management.

An underlying premise of S. 1005 and its House counterparts is that the entire railroad industry should be singled out and made the subject of special legislation regulating debt-financed acquisitions. But if leveraged buy-outs are a problem at all for the railroad industry -- and I am aware of no evidence or support for such a conclusion -- they are a problem for every segment of American industry. I do not believe railroad services should be singled out and treated any differently from other goods and services in this respect. When the Interstate Commerce Act was passed in 1887 conferring ICC jurisdiction over rail carriers, the railroads probably were the most important industry in the United States. Today, however, whether in terms of dollars, number of people employed, or by any other measure, the railroads are relatively small players within the total realm of American industry. If the creation of debt from leveraged buy-outs is a subject of concern at all, it is simply not unique to the railroad industry.

Throughout the history of American industry, no other segment been as thoroughly and completely regulated as have the railroads. Since the late 1970's, which saw over 20% of American railroads (by mileage) in bankruptcy and others with severe financial problems, the railroads have managed to achieve substantial improvement in all aspects of their business. Through gains in productivity and efficiency permitted by deregulation, the railroads have improved cash flows, increased the amount of freight traffic handled, and virtually eliminated deferred maintenance and equipment shortages. The quality of rail service has improved and the users of that service have generally enjoyed increased competition and lower rates. The turning point which made these dramatic improvements possible was the Staggers Rail Act of 1980.

The basic principle of the Staggers Act is that railroads are a business and ought to be permitted to act much as other business in managing their assets and pricing their services free from the regulatory restraints of the past. In short, Congress correctly recognized in passing the Staggers Act that railroad management should be subject to less, not more, government regulation. The success of the Staggers Act within the rail industry reinforces a concept which is fundamental to the entire American economy: that the discipline of the free market ultimately benefits the American public by providing incentives to producers of goods and services to reduce costs and increase productivity.

American railroads must be permitted the freedom to meet the challenges of today's environment of global competition on an equal footing with all participants, both domestic and foreign. The costs and burdens of needless regulatory constraints such as those proposed by S. 1005 would lessen the competitive ability of American railroads.

Even with the Staggers Act freedoms today's railroad industry, probably more so than any other industry, is the subject of burdensome special legislation. One good example of such special legislation is the Federal Employers' Liability Act, which imposes greater liability costs on railroads than those to which other industries are exposed. If enacted, S. 1005 would be another example in my opinion.

This proposal to add regulatory constraints upon the acquisitions of railroads by non-carriers is, therefore, a step in the wrong direction. The presence of return-oriented non-carrier investors with the ability freely to acquire controlling interests in railroad-related companies is a very potent example of the discipline of the free market. If that free market discipline is removed by the imposition of burdensome and unnecessary regulatory constraints such as are embodied in the S. 1005 proposal, existing management of any railroad or railroad holding company could have less incentive to manage efficiently.

In the long run, the railroad industry, its customers, and ultimately the consuming public will be the losers if proposals such as S. 1005 are enacted. Santa Fe therefore urges the Subcommittee to reject the pending proposal to confer ICC jurisdiction over non-carrier acquisition of control of Class I railroads.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

Question. Current law requires ICC approval where one railroad seeks to purchase another railroad and where a non-carrier seeks to purchase two or more carriers, regardless of their size. In terms of a level playing field, do you see any compelling reasons why a non-carrier acquisition of a Class I carrier should be exempt from all ICC evaluation as to its plans for continued operation of the railroad? What if strict time limits were imposed on such review?

Answer. I find argument that existing railroads are disadvantaged by an "uneven playing field" when they compete with a non-railroad for acquisition of another railroad to be an interesting line of reasoning; but I do not believe it has any basis in fact. I am unaware of a real life case where a railroad actively competed with a non-railroad to purchase another Class I railroad and the non-railroad succeeded in that open market competition. In fact, it appears to me that in the situation that spawned this proposed legislation, the non-railroad Japanica lost out to the Blackstone bid, and Blackstone is a railroad enterprise.

Since there is no real life inequity to be corrected with the proposed legislation, I believe there continues to be a valid distinction between consolidations of two or more railroads, over which the Interstate Commerce Commission has jurisdiction, and acquisition of a single rail system by a non-carrier, over which the ICC has no jurisdiction. The primary purpose of conferring jurisdiction over the former was to assure that consolidation of existing railroads would not result in an unreasonable diminution of competition among them—a purpose not applicable to acquisition of a single railroad by an entity which has no other carrier interests.

Absent this purpose and absent any indication that existing railroads suffer from an uneven playing field when they compete with non-railroads for control of another rail property, the negative results of conferring jurisdiction pointed out in my testimony presented on June 22, 1989 before the Surface Transportation Subcommittee of the Senate Committee on Commerce, Science and Transportation provide compelling reasons not to do so.

In short, regulatory uncertainty, delay and potential labor protective conditions would discourage return-oriented stock purchasers, resulting in a decline of rail stock prices and a corresponding increase in the cost of equity. This would directly harm the thousands of investors in rail stocks and indirectly harm the railroads by increasing the cost of the equity segment of their capital structure.

If the Committee should decide that Congressional intervention is required, which I do not believe is the case, I urge that very strict limitations be placed upon any review by the Interstate Commerce Commission and that labor protection not be required.

Senator EXON. Thank you, Mr. Swartz.

Mr. VOYTKO.

STATEMENT OF JAMES VOYTKO, DIRECTOR OF RESEARCH AND TRANSPORTATION ANALYST, PAINE WEBBER

Mr. VOYTKO. Thank you very much, Senator. I am pleased to be here. My name is Jim Voytko. I am the Director of Research at PaineWebber and also have responsibility for analyzing the surface transportation industries, especially the railroads.

As I understand it, there are three general questions before the committee relating to S. 1005. First, should you empower the ICC to review and regulate the purchase of rail carriers by non-rail entities. Second, should the ICC be empowered to rule on the acceptability of the debt which would result from an acquisition; and third whether the commission should be empowered to rule on the acceptability of the potential effects on service and employment.

My answers to those three questions are simple: No, no, and no.

On the first question I believe that there really are only two reasons for the government to regulate any acquisitions. The first is on the grounds of national security, which I think most people would agree do not apply here. The second is to prevent the creation of effective monopoly power. Monopolies are bad; they are harmful, and it is certainly well within your purview to act to regulate them and to preserve vigorous economic competition. But it is hard to see from the point of view of this rail analyst how the acquisition of a rail carrier by an entity that owns no other rail assets or even one that owns no contiguous rail assets could change the competitive state of the industry.

I think also that we should all be ecstatic that anyone at this point is willing to step forward and risk capital by purchasing rail assets given that the risks and the long-term liabilities that lie within the rail industry are quite daunting. We have rail retirement; we have the threat of potential reregulation. The fact that people are willing to step up and put some new capital in the industry is something we should all be happy about that.

On to the question about how much debt is too much. The argument about whether the Federal Government should regulate the use of debt in the purchase of a railroad is really a mirror of the debate that continues inside and outside the Congress over the use of debt for acquisitions of corporations generally.

This is really the LBO issue, albeit micro form. And the many objections to government intervention in the use of debt versus equity in acquisitions generally, holds true in the case of railroads as well.

It is hard to see who in the Federal Government would be able to know when a buyer, or an existing owner for that matter, is using too much debt. Businesses can fail from the excessive use of leverage: no question about that. That is an economic fact of life.

But successful businesses can also be built, enhanced or rescued via strategies employing substantial leverage. For example, it was the Federal Government, itself, which lent further funds to an already leveraged Chrysler Corporation, a leveraged strategy which helped save that company.

Indeed, I would argue that most of the people in this room who have home equity built up over time probably acquired this wealth from what in effect is a leveraged buyout of real estate with small down payments relative to the size of the property.

Indeed, those of us who used student loans to finance our education and our career did what, in effect, was a nearly infintely leveraged investment. The good thing about the private sector is that there are lots of people out there who assess appropriate uses of debt for a living and who have heavy penalties if they do it wrong.

For example, think of the heavy price the mangagement and the shareholders of Penn Square, Seafirst, Continental, M-Corp, Financial Corp of America, have all paid for incorrectly analyzing the appropriate application of debt. Conversely, those who do it well are economically rewarded.

But, when you give this power over to the Government, to a government agency, they face no penalty if they do it incorrectly, and prevent a beneficial transfer of ownership accommplished via the use of borrowed capital.

Moreover, even if they estimate correctly, there is nothing in it for them. They really have no incentives. It is hard to argue that the Government can assess the appropriate use of leverage in scores of railroads, much less the 10s of thousands of U.S. corporations better than negotiations between a willing lender and a willing borrower.

The only difference between the general case of leveraged buyouts and the specific case of the rails before you, is that the railroads industry labors under the legacy of a Federal policy that assumes it is both fair and rationale to treat the rails differently than other industries in America.

The Federal government imposes on them a different and more burdensome labor relations statute, a different and more costly employee injury compensation system, a different and more costly retirement system. It is quite likely that the Congress will properly, in my view, sense that the LBO issue is best left alone for corporate America to resolve but continuing along—and I think unwholesome line of thought—put more restrictive capital usage restrictions on the railroads, again treating them differently and more restrictively.

Let me mention a few things about the general LBO issue. We worry, I think quite rightly, about whether the industries will be adversely affected by debt; whether, as Senator Pressler said, I believe, that the economy will be too brittle. But one of the things that you and your collegues in the Congress have at your fingertips, if you feel there is a leverage problem in the U.S. economy, are the two policies that I believe lie at the heart of it.

They are deposit insurance, which biases the behavior of lenders, and the double taxation of the dividends, which makes corporations and acquirers of railroads choose tax deductible debt over taxable equity every time.

These are at the root of why people are using debt in corporate America. These two policies and the beneficial effects of having debt being pressed on a management team that has to produce are leading owners to choose debt over equity at the margin. If you are concerned about the use of leveraging the rail industry, then you should be concerned about its use throughout corporate America. And, I think this should lead you directly to deposit insurance and the double taxation of dividends.

With respect to regulating service and employment in the industry, I have had the pleasure of serving in the ICC and I think that it would be very difficult for the Commission to better guess what the present and future needs of shippers are with respect to service, or what employment levels are economically practical and most efficient. No not compelling propositions: Arguing that the Commission can do this better than the railroads can do it themselves is. Remember that we are in an economic climate where the particular types and levels of service desired by shippers is changing very rapidly: double-stack service replacing traditional intermodal, the emergence of new and different types of equipment.

What is now perceived as an economically practical and efficient labor arrangements is quite different than just five years ago and changing rapidly even as we speak. It is hard to argue the IRC is on the leading edge of developments in this critical area.

I have included with my written testimony which I have submitted, some data and excerpts from research Paine Webber has done on LBO's debt and related issues. I hope you find it useful and I thank you again for the opportunity to comment today on these issues.

[The statement follows:]

STATEMENT OF JAMES M. VOYTKO, DIRECTOR, RESEARCH AND TRANSPORTATION ANALYST PANE WEBBER, INC.

Good afternoon Mr. Chairman and Members of the Committee. My name is Jim Voytko and I am currently Director of Research at PaineWebber a major brokerage and investment bank based in New York. I continue to analyze the surface transportation industries and have had the pleasure of serving in several Federal agencies including the ICC. I am pleased to be asked to appear once again before the Committee to discuss debt and control issues in the continuing consolidation of the rail industry.

As I understand it, there are three general questions before the Committee.

First, should the ICC be empowered to review and regulate the purchase of rail carriers by non-rail owning entities?

Second, should the ICC be empowered to rule on the acceptability of the debt which would result from an acquisition of a rail carrier?

And third, whether the ICC should be empowered to rule on the acceptability of the potential effects on service and employment from an acquisition of a rail carrier.

My answers to these three questions are no, no and no.

Regulating Non-Rail Acquirers of Rail Carriers

There are many reasons why it makes little sense for the Federal government to interfere in a proposed acquisition of a rail carrier by a non-rail owning entity.

First, in my view the only proper reasons for the government to regulate any acquisitions is to either ensure national security (which doesn't apply here) or to prevent the creation of effective monopoly power. Monopolies are indeed harmful and it is well within the role of government to take action to prevent them and preserve vigorous economic competition. But, it is hard to see how the acquisition of a rail carrier by an entity which owns no other rail assets or even one which owns no contiguous rail assets could change the state of either intra or intermodal competition for the right to serve shippers.

Second, the Federal government should be ecstatic that anyone is willing to to risk capital by purchasing rail assets given the shrinkage in the rail system, the history of punitive regulation and the threat Congress might reimpose it, as well as the longterm liabilities inherent in the rail retirement system. These are all factors that should lead public officials to welcome any renewed interest in owning railroads.

There may well be instances in which some observers don't like the acquirers because they're too young, too poor, too rich, too inexperienced, propose radical changes in the operation of the railroad, or simply lack social grace. These and a host of other factors limited only by one's imagination don't seem to me to be valid concerns of the government. But, once you empower regulators to rule on the acceptability of a proposed acquisition--beyond the unavoidable issue of antitrust--you risk having these and other irrelevant even insidious factors creep into their decisions.

How Much Debt Is Too Much Debt?

The argument as to whether the Federal government should directly regulate the use of debt in the purchase of a railroad mirrors the debate that continues inside and outside the Congress over the use of debt for acquisitions of corporations generally. And the many objections to government intervention in the use of debt versus equity in acquisitions generally hold true in the case of rails.

Who in the Federal government knows when a buyer (or an existing owner for that matter) is using too much debt? Businesses can fail from excessive use of leverage. That is a fact of economic life. But, successful businesses can also be built, enhanced or rescued via strategies employing substantial leverage. In the private sector, whole industries exist where competitors vie to more correctly estimate the risks and rewards of the use of leverage in any given situation. More importantly there are severe penalties for being worse than your competitors at assessing the use and users of leverage. For example think of the heavy price the management and shareholders of Penn Square, Seafirst, Continental, M-Corp, Financial Corporation of America, have paid for incorrectly analyzing the appropriate application of debt. On the other hand, lenders, investment bankers and brokers who succeed in correctly estimating the risks and rewards in any given use of leverage are themselves rewarded economically.

Who inside the government, who inside the ICC--an agency some of your colleagues in the other body have characterized as brain dead--has the capability of better assessing the acceptable uses of leverage than the companies whose livelihoods rest on doing it right? But, more importantly, what is the penalty the individuals at the ICC face if they guess wrong and are too restrictive, preventing beneficial transfers of ownership accomplished via the use of borrowed capital. There is none. And is there any specific reward if they estimate correctly. No. The use of leverage in a corporation is a strategic decision the owners must make within the limits set by the providers of borrowed capital. Some owners (and lenders) will make bad decisions, will take on more leverage than their entities can bear and will fail. But can the government truly argue that its assessment of appropriate leverage in the tens of thousands of U.S. corporations is better than that of a willing lender and a willing borrower?

The only difference between the general case and the rails specifically is that the poor railroad industry labors under the legacy of a benighted Federal policy that assumes it is both fair and rational to treat the rails differently than other industries in America. The government imposes on them a different and more burdensome labor relations statute, a different and more costly employee injury compensation system, and different and more costly retirement system. The danger here is that the Congress will properly sense that the relative dependence on debt versus equity in U.S. corporations generally is a matter best left to those on the scene with a major stake in striking a successful balance between the two but continuing a long and unwholesome line of thought, then impose a different and more restrictive set of capital usage restrictions on the owners or bidders for rail assets.

A General Point on the LBO/Debt Issue

Some would argue at this point that there is evidence that lenders, acquirers and corporations too readily create debt in quantities too large to sustain viable economic operations. They use this argument to justify empowering government agencies to interfere in the negotiations between a willing lender and a willing borrower--protecting them from themselves so to speak. You know there may some truth to this view. But, even if true this does not justify treating railroads differently than other corporations and restricting rail owners would do nothing to help any overall problem with leverage. Moreover, given the government's lack of expertise and incentives to succeed, it hardly seems likely government agencies will make better decisions than the private parties who have so much at stake.

However, you and your colleagues in the Congress do indeed have at your fingertips the two levers which may contribute to any policy-induced leverage problem in the U.S. economy. They are deposit insurance (which biases the lender's behavior) and the double taxation of dividends (which makes corporations choose tax-deductible debt over taxable equity). If you are concerned about the use of leverage in the rail industry, then you should be concerned about its use throughout corporate America. In my opinion these concerns should lead you directly to deposit insurance and the double taxation of dividends. But enough on this which I presume is the purview of another committee.

Regulatory Service and Employment

If the Congress empowers the ICC to regulate rail acquisitions based on the Commission's forecasts of the potential effects on service and rail employment, it will in effect be saying that the Congress believes the ICC is a better judge than either the free market or the actual providers of rail service:

(1) of the present and changing future service needs of shippers and

(2) the employment levels that are both economically practical and most efficient.

These are not compelling propositions in an economic climate where the particular types and levels of service desired by shippers and the economically practical means for the rails to produce them is changing so quickly. Don't insert a group of undoubtedly well-meaning but permanently inexperienced and permanently unaccountable Washington bureaucrats between the railroads and their customers and employees. For indeed, if you believe the ICC can judge the merits of an acquirer's operating plan and prospects better than he, his lenders and investors and his prospective customers can, then this is tantamount to saying the Commission is smarter and more far-sighted than existing managers as well. That line of logic taken to its conclusion leads to the ICC running the U.S. rail system. Always recognizing the fallibility of any management team, I prefer to take my chances with private sector owners and managers, and their strong incentive to get the job done right.

Appendix

The following is a brief snapshot of some data and research commentary drawn from recent research on these issues by the PaineWebber Research Department. The bulk of the data comes from the following reports:

-- LBOs: The Next Achilles' Heel? dated November 30, 1988 by Sandra Flannigan and Brenda McCoy and

-- "Beyond the Debt Deluge: Growth Regains its Glamour in the '90's" dated June 15, 1989 by Thomas Doerflinger, Edward Kerschner and Michael Geraghty.

A variety of Factors Have Lead to Increased use of leverage in corporate America, especially in acquisitions (LBO's).

> **"Four strengths of LBOs**
>
> To properly assess the future of LBOs and other forms of leveraged shrinkage, one must recognize their strengths. Four stand out. Most obviously, the tax code heavily favors debt over equity. Interest payments can be paid out of aftertax dollars. The total (Federal plus state) marginal tax rate faced by corporations is in the neighborhood of 40%. If $1 million is paid out by a corporation as dividends, its aftertax cost is $1 million; paid out as interest, it is just $600,000 million. In part, leveraged shrinkage merely represents a reconfiguration of balance sheets toward a tax-advantaged form of capital. Unlike the increase in consumer and government debt, the leveraging of corporate America is not associated with a decline in national savings.
>
> Second, many publicly traded companies are worth more if they are dead and divided because the replacement value of the assets (net of debt) greatly exceeds their valuation by the stock market. Even after the bull market of the 1980s, Federal Reserve

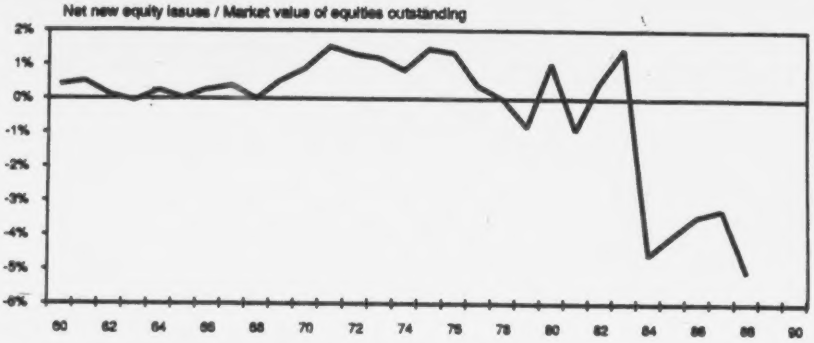
figures still indicate that the net tangible value of corporations exceeds market value by a large margin.

LBOs have also prospered because they provide a method of reversing ill-advised conglomerate mergers. The "synergy" claimed for conglomerate mergers has been elusive: in the real world 1 + 1 + 1 has more often equaled 2 than 4. A conglomerate's operating divisions are weighted down by the expense of headquarters staff--not to mention the bureaucratic burden of constantly reporting to a boss at headquarters. No matter how good its intentions, a conglomerate's top management does not have intimate knowledge and a "gut feel" for the business operations of their far-flung divisions. The line managers who operate each division have limited latitude to respond in a swift, entrepreneurial fashion to market opportunities. Lacking an ownership stake, their incentive to excel is also attenuated. LBOs correct these manifold defects of conglomerates by liberating division managers. Academic studies show that profit margins tend to expand after companies go private.

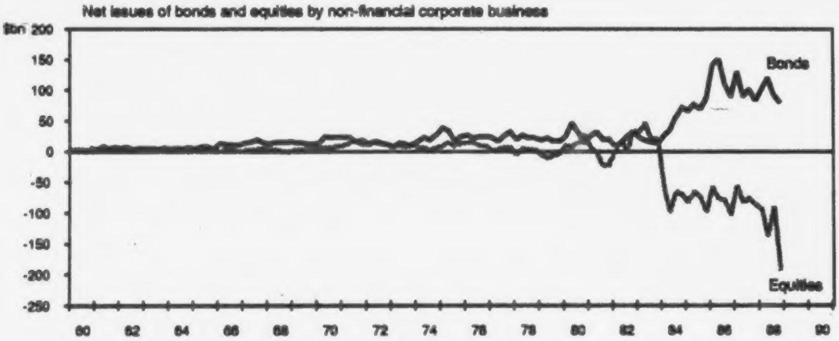
A fourth reason for the success of LBOs in the 1980s--often overlooked by their architects--is that the economy has cooperated. From 1982 through 1986, real GNP expanded while interest rates were declining. Though interest rates rose in 1987 and 1988, economic growth accelerated and profit margins expanded impressively. As for 1989, it is shaping up as a year of slower but still acceptable growth, shrinking profit margins and level interest rates. In short, 1983-89 has been a wonderful time to run a leveraged company. And during much of this period, slack labor markets and weak unions made it relatively easy for hard-nosed managers to cut labor costs. In this surprisingly benign environment many transactions that appeared to be very risky when they were announced have worked out perfectly, vindicating the promoters while silencing their critics."

This trend (and the increased use of debt in defending against hostile LBOs) has led to:

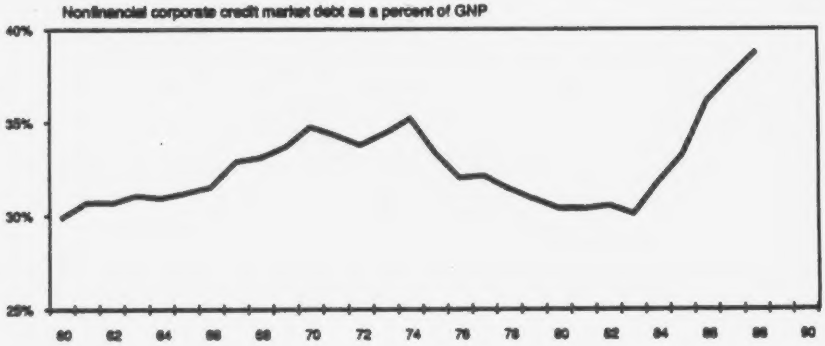
1. declining use of equity capital



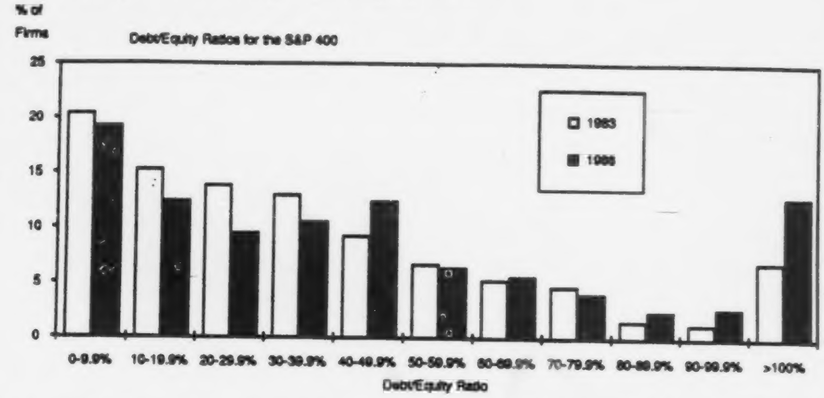
2. increased issuance of debt



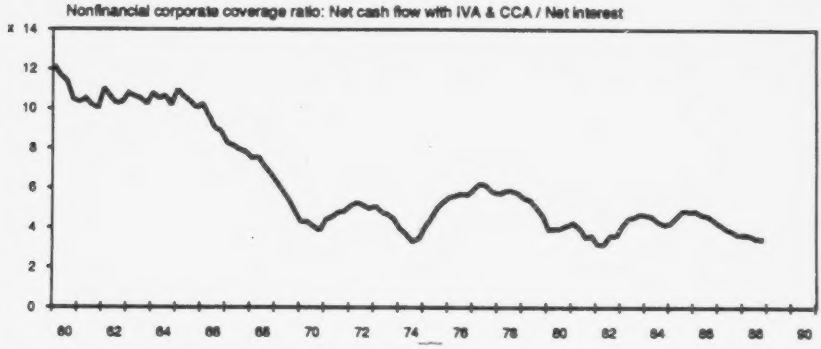
3. a rise in nonfinancial corporate debt versus GNP



4. a rise in companies with high debt/equity ratios

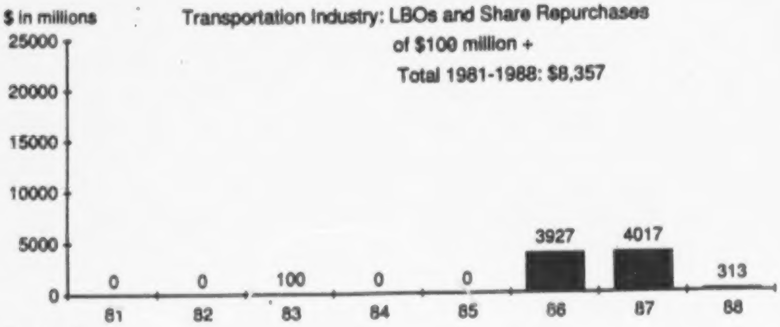


5. a decline in the ratio of corporate cash flow to interest expense despite a prolonged economic recovery



* Net cash flow = Aftertax profits - Dividends + Depreciation

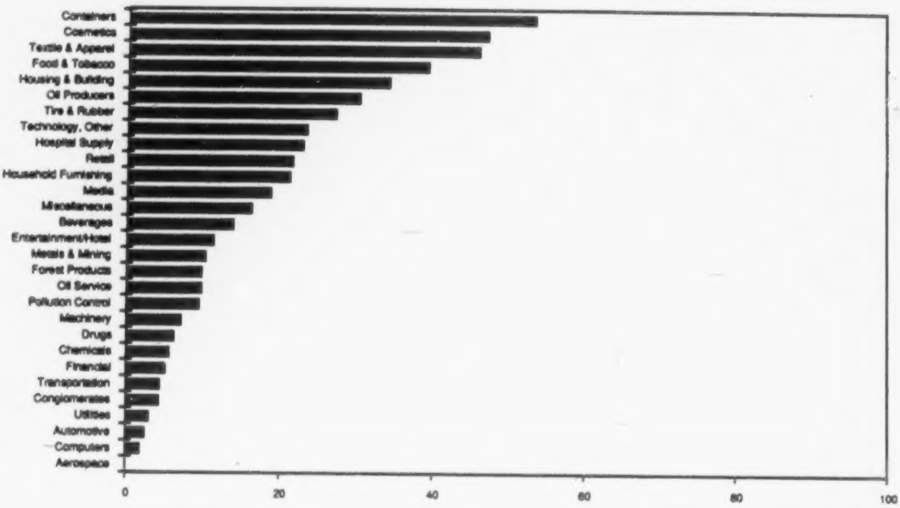
Overall, the transportation industries have not been disproportional participants in the trend toward greater use of debt.



Transportation

Date	Company	$ Value in millions
1/83	CCI Corp.	100
9/86	Avis-Rent-a-Car Systems (franchise ops)	1,850
9/86	Budget Rent a Car	205
9/86	Sun Carriers	180
12/86	Mayflower Group Inc.	233
12/86	National Car Rental System	1,459
3/87	Greyhound Lines	350
6/87	Leaseway Transportation	495
9/87	Avis Inc.	1,750
10/87	Lakes States Transport. (div/Soo Lines)	122
12/87	Hertz Corp.	1,300
10/88	Arkansas Best Corp.	313
Transportation total		$8,357

Where the debt is: percentage of market capitalization of S&P industry groups disappearing, January 1984-November 1988



But without a doubt, share repurchases, LBO's, recapitalizations etc. have resulted in greater use of debt among rail holding companies during the 1980's.

Rails -- Debt/Equity 1980 - 1988

	1980	1984	1988	Q189	Comments
CRR (1981)	119.0%[1]	171.0%[2]	23.7%	24.0%	Privatization Act has kept leverage inefficiently low.
NSC	46.0%	21.5%	15.0%	14.6%	Is currently embarked on a modest share repurchase program which if extended could increase leverage.
CSX	78.3%	67.2%[3]	69.9%	109.0%[4]	Dutch auction share repurchase funded in part by larger debt.
CNW	304.0%	304.0%[5]	126.0%	147.0%	Leverage will rise further with buyout.
BNI	63.6%[6]	79.2%[7]	308.0%	307.0%	"Internal" LBO has left railroad with greater debt.
UNP	56.5%	60.5%[8]	74.9%	70.7%	Recent dutch auction share repurchase will boost leverage further.
SFX	37.4%	31.5%	776.0%[9]	532.0%[10]	Special dividend funded largely through increased debt.

(1) Deficit of $1,522,838 added by to equity. Otherwise D/E = 1151%.
(2) Includes $374M Preferred Stock.
(3) Includes $331M P/Stock. Absent this, D/E = 60.3%.
(4) Includes $143M of short-term debt + 119M P/Stock.
(5) Includes 114M P/Stock. Absent this, D/E = 258%.
(6) 68% if Preferred Stock is included.
(7) Includes $697M in Preferred Stock as debt. Absent this amount, D/E = 62.5%.
(8) Includes $374M Preferred Stock.
(9) 254% if Treasury stock is added back to equity.
(10) 216% if Treasury stock is added back to equity.

Senator EXON. Mr. Voytko, thank you very much.
Mr. Runde.

STATEMENT OF JAMES A. RUNDE, MANAGING DIRECTOR OF MORGAN STANLEY & CO. INC.

Mr. RUNDE. Good afternoon, Senator. I am James Runde and I am Managing Director of the investment banking firm of Morgan Stanley. I am responsible for all of Morgan Stanley's work with railroads and other transportation companies.

Morgan Stanley has managed, or co-managed, since 1978, about 55 public financings with an aggregate value of over $5 billion for railroads. We have also been retained as financial advisor in a variety of railroad-related transactions, including the Burlington-Frisco merger, the Soo Line-Milwaukee merger and the Santa Fe-Southern Pacific matter.

We also were the advisor to Consolidated Rail Corporation in its privatization process and were co-manager of the IPO of Conrail. And I was personnally involved in all of these transactions.

We thank you for the opportunity to appear before you today on behalf of Morgan Stanley. I would first like to commend you and the subcommittee for the fair and balanced manner in which you are conducting your deliberations on this subject.

Issues such as these often arise in the context certain fact-specific situations. It is, therefore, extremely important to stop and consider, as the subcommittee is doing today, the general policy ramifications of legislation such as S. 1005, to determine whether it will have an unintended, adverse consequence that extends beyond those originally envisioned.

My goal today is to provide you with my perspective on certain of the more serious adverse consequence that could result from this proposed legislation. Legislation that we are discussing today is proposed as a mechanism for ensuring the long-term financial health and rail freight service of each Class I railroad and the U.S. railroad system in general.

I would submit, however, that while the intent of the legislation is to preserve service levels, competition and financial viability in the railroad industry, it is most likely to produce unintended and undesirable consequences.

Specifically, I believe that this proposed legislation will impede all railroads' access to capital and increase all of their cost of capital, and result in fewer railroad jobs, raise the cost of rail service to shippers and create a railroad system that is less competitive with other modes of transportation.

Ultimately, this could lead to the type of unresponsive regulatory environment that existed prior to 1980, which resulted in the financial collapse, or near collapse, of many of the Nation's railroads, and caused untold hardships to taxpayers, rail shippers and rail employees.

In addition, it is my judgment that since the ICC review process is likely to add substantial delay to the acquisition of the railroad company, the market will factor this delay and expense, as well as a risk of a veto by the ICC, into the transaction by lowering the value of the railroad, to the detriment of the customers, the company and its shareholders.

This legislation would also create long-term downward pressure on railroad stocks and increase the cost of capital for all railroads and railroad holding companies.

Potential investors would view this legislation negatively for several reasons.

The first is the perception that management would not be subject to the same market discipline as other corporations and might not, therefore, provide competitive operating financial results.

Second, the delay and uncertainty associated with an ICC review process will reduce prices paid in acquisitions. Finally, I believe that such legislation could potentially be viewed as a precursor to further industry reregulation, which would reduce financial returns even further.

I would note that capital ratios in the railroad industry are not proper determinants by which to judge a company's quality. Railroads are not like financial institutions or banks. There is more to quality railroad service than can be predicted or deduced from financial ratios.

The service provided by a railroad carrier to its shippers is dependent upon, among other things, its marketing strategy, its operating efficiency, its labor relations, its maintenance policies, corporate culture and leadership, and the overall ability and interest in responding to shippers' needs.

A railroad that is not significantly leveraged does not necessarily provide excellent rail service and, conversely, my experience is that a highly leveraged railroad does not necesarily provide inadequate or reduced levels of service.

In conclusion, I am concerned that this first step to limit financial leverage in the railroad industry and establish capital standards is neither warranted nor justified. Furthermore, it may also be like allowing the nose of the camel under the tent.

Do we next regulate railroad dividend policy? The issuance of all public and private debt and equity securities by railroads? Stock repurchases? All capital structure issues in the railroad industry? And do we turn these over to the ICC for the determination of appropriate financial measures?

It seems to me that we have been down a similar path before; the path that led to the Rock Island, the path that led to the Penn Central. The over-regulation that existed until the 1980s had much to do with these poor competitive and financial performances.

I would submit that this Bill has the potential to spark exactly such additional reregulation, all of which will competitively disadvantage all railroad companies relative to other coroporations in the marketplace with regard to their cost and access to capital. Ultimately, increasing the cost of capital for all railroads will raise the cost of rail service to shippers.

Lastly, the railroad industry should not be singled out for regulation with respect to mergers and acquisitions. Railroad companies are no different from any other company in this regard. Railroad acquisitions, therefore, should be discussed in the context of the entire Federal regulatory framework for mergers and acquisitions.

And to the extent a problem exists, a narrowly-defined solution that addresses specific merger-related problems should be carefully crafted rather than an arbitrary layer of industry-specific regulation.

I would be happy to answer any questions.

[The statement and questions and answers follow:]

Statement of James A. Runde to the Subcommittee on Surface Transportation of the U.S. Senate Committee on Commerce, Science and Transportation

June 23, 1989

Mr. Chairman and members of the Subcommittee, I am James A. Runde and I am a managing director of the investment banking firm of Morgan Stanley & Co. Incorporated (Morgan Stanley). I thank you for the opportunity to appear before you today. Since 1981, I have been responsible for all of the firm's client relationships with the railroad industry and have had extensive personal involvement in numerous railroad related transactions, including major railroad mergers, restructurings, and financings. In Attachment A to this testimony, I have provided additional information on my professional background, together with a general description of Morgan Stanley and its involvement with the railroad industry.

Introduction

On behalf of Morgan Stanley, I would first like to commend the Chairman and this Subcommittee for the fair and balanced manner in which you are conducting your deliberations on this subject. We believe that upon thorough review of this matter you will conclude that legislative changes are not warranted or justified in response to recent corporate restructurings in the railroad industry.

My purpose today is to provide material that will be helpful to your consideration of S.1005, legislation that would charge the Interstate Commerce Commission (ICC) with regulatory review of the "acquisition of control of a Class I railroad by a non-carrier." In addition, I understand that my views are also requested with respect to expanding the scope of such ICC review to various financial transactions, including internal corporate restructurings and other transactions that would increase the leverage of a Class I railroad.

The current purview of the ICC with respect to acquisitions in the railroad industry is limited to those involving two or more railroads. Its primary focus has been to protect against excessive market power that could lead to reduced competition and abusive pricing power. As I understand it, the legislation proposed in S.1005 would extend the ICC mandate to a review of hypothetical railroad service levels subsequent to an acquisition by a non-railroad entity. Such a process might well lead to the establishment of complex capital standards in the railroad industry, or in other words -- financial reregulation. Moreover, it would jeopardize the railroads' ability to raise debt and equity capital. In my opinion, such results would be detrimental to the railroad industry.

Using projected rail service as the basis for an ICC veto of a change in control poses major quantitative and qualitative difficulties. There is more to the concept of quality rail service than can be predicted by financial ratios; the service provided by a railroad carrier to its shippers is dependent upon, among other things, its marketing strategy, operating efficiency, labor relations, maintenance policies, corporate culture and leadership, and overall ability to respond to shipper needs. A railroad that is not significantly leveraged does not necessarily provide excellent rail service, and conversely a highly leveraged railroad does not necessarily provide inadequate or reduced levels of service. A railroad that provides exceptional service that is uneconomic will soon become financially troubled. Moreover, being a public company does not guarantee access to capital or financial viability. It has been my experience in the railroad industry that financial restructurings usually produce operating and financial improvements and that important equity incentives provided to management in leveraged transactions often lead to reduced operating costs, improved productivity and service, and heightened sensitivity to shipper needs.

The legislation that we are discussing today is proposed as a mechanism for ensuring the long-term financial health and rail freight service of each Class I railroad, and the U.S. railroad industry in general. However, I would submit that while the intent of this legislation is to preserve service levels, competition, and financial viability in the railroad industry, it is most likely to produce unintended and undesirable consequences. Specifically, I believe that this proposed legislation will impede all railroads' access to capital and increase their capital costs, result in fewer railroad jobs, raise the cost of rail service to shippers, and create a railroad system that is less competitive than other modes of transportation. Ultimately, this could lead to the type of unresponsive regulatory environment that existed prior to 1980, which resulted in the financial collapse or near collapse of many of the nation's railroads and caused untold hardships to taxpayers, railroad shippers, and railroad employees.

In addition, I believe that a company's ability to attract capital from sophisticated investors -- banks, insurance companies, pension fund managers, and other major suppliers of capital --is the best evidence of the financial viability of a railroad company, or any company for that matter. Furthermore, the ICC is ill-equipped in terms of resources and expertise to address the financial issues raised by this legislation, nor has it embraced such a mandate.

Revitalization of the railroad industry after decades of a deteriorating competitive position relative to other transportation modes, particularly trucks, has come only after financial and commercial deregulation of the industry in the past ten years. As a result of all the above, I conclude that financial reregulation of the railroad industry such as that proposed in S.1005 is unnecessary to ensure financial viability and service levels in the railroad industry and will be, in fact, counterproductive to that objective.

Financial Viability Measured by Access to Capital

As I mentioned, it has been my experience that a company's financial viability is best measured by its ability to attract capital to fund its business opportunities. In an acquisition, the marketplace provides perhaps the best evidence of a company's viability, because major institutional investors who commit hundreds of millions of dollars to a transaction do so because the post-transaction company will be a strong going concern. In reaching such a conclusion, these investors consider both the operating prospects for the company and its industry as well as an analysis of credit statistics which serve as a measure of a company's ability to meet its financial obligations to lenders. Recent transactions in the railroad industry (the merger of Southern Pacific Transportation Company with Rio Grande Industries, the acquisition of Illinois Central Transportation by Prospect Group, and the pending acquisition of CNW by Blackstone Group Inc., Union Pacific, and management) have been financed by some of the most sophisticated lending institutions and corporations in this country. In particular, I would note that the participation by CNW management in that transaction is indicative of a conviction about the financial prospects of CNW.

Management has an important financial and personal stake in the new venture.

The ICC Review Process

Historically, the ICC's purview with respect to rail acquisitions, while broad, has been focused on the competitive issues related to the combination of two or more rail carriers. In this regard, I believe that the ICC, with its specialized knowledge and experience in the freight transportation sector in general, and the railroad industry in particular, is probably well qualified to conduct such a review and provide oversight of any anticompetitive or otherwise improper concentration of control of rail freight services in this country. The function that the ICC performs in such intra-industry combinations is similar to that which the Department of Justice, for example, performs in enforcing antitrust laws in mergers of companies in non-regulated industries.

Under existing law, the ICC also has jurisdiction to approve or disapprove the issuance of securities by a rail carrier and to consider, among other things, the purpose and use of proceeds of any such issuance. While there may be a question as to the continuing need for such jurisdiction, it is at least theoretically tied to the Commission's historical role in the transportation industry. On the other hand, the new jurisdiction proposed for the Commission deviates significantly from and expands upon the Commission's mandate. I believe the ICC is not properly equipped, in terms of personnel or expertise, to address the single carrier capital structure and financial issues proposed in this legislation.

Currently, the ICC has up to 31 months to review proposed railroad mergers. Traditionally the ICC has utilized most, if not all, of this available time to review transactions. A notable exception was the end-to-end merger of Southern Pacific and Rio Grande in 1988. In this case, the ICC conducted an expedited six month review process. However, the Commission had been reviewing the Southern Pacific situation for approximately five years. Historically, however, the ICC has had a poor record with respect to the timely review of proposed financial and acquisition matters in the railroad industry, particularly when its regulatory role was more extensive. Delay in ICC review of proposed railroad debt financings in the 1960's and 1970's resulted in carriers seeking alternative funding sources and in many missed market opportunities. Consider the eleven years that elapsed before the ICC completed its review of the proposed purchase of the Rock Island railroad by the Union Pacific and Southern Pacific; the delay itself contributed to Rock Island's bankruptcy. In the end, the ICC substituted its own acquisition plan which none of the participant railroads wanted.

The collapse of the Penn Central Railroad is perhaps one of the best known examples of the consequences of the delay inherent in an extensive ICC review process. Penn Central was created through a merger of equals and involved no new debt. Its demise has been ascribed in part to the six year ICC review, which caused a significant reduction in the capital expenditures of both railroads. Furthermore, the ICC required the inclusion of the New Haven railroad in the merger and job protection for labor; moves that were not originally foreseen and which drastically changed the economics of the transaction. Using the concept of a bill such as S.1005 to link service with leverage and to subject railroad financial matters to the delay and uncertainty that seem inevitably to accompany ICC review simply invites similar kinds of problems.

While ICC review of a railroad acquisition by a non-railroad should not require the same competitive review as an intra-industry transaction, the approval process could still be quite lengthy -- in excess of 90 days. Furthermore, the required ICC filings could well take an additional two months or more for a potential acquiror to complete. I am skeptical that the ICC could respond to such transactions in a timely manner.

It is my judgment that since the ICC review process is likely to add substantial delay to the acquisition of a railroad company, the market will factor this delay and expense, as well as the risk of an ICC veto, into the transaction by lowering the value of the railroad to the detriment of the company, its customers, and shareholders.

Contrast the likely ICC review process with the SEC tender offer process for purchasing the common stock of a publicly traded company. In this situation the offer to purchase is typically outstanding for the minimum 20 business days. If Congress decides to proceed with S.1005, I strongly urge you to limit ICC review to the SEC documents and timetable.

Implication for Management of Railroad Companies

The extension of ICC jurisdiction to an appraisal of railroad companies' financial structure, capacity, and viability subsequent to an acquisition by a non-railroad entity or internal restructuring could well serve to entrench existing railroad management. I believe that the existence of return-oriented financial buyers is, on balance, positive for the railroad industry. In the current unregulated railroad environment, management of railroad companies, like management of other publicly traded corporations in the United States, compete for debt and equity capital based on their historical and expected financial performance. Financial return expectations by investors provide an important impetus for railroad management to operate competitively and efficiently to obtain capital to fund their operations on attractive terms. A heavily regulated railroad industry will have difficulty attracting innovative and entrepreneurial business people. The adoption of this legislation could, in my view, lead to entrenchment of existing management because they would see little risk to acquisition by a third party and thus have reduced incentive to achieve competitive results.

Capital Markets Reaction to the Proposed Legislation

This legislation would, in my judgment, create long-term downward pressure on railroad stocks and, hence, increase the cost of capital for all railroads and railroad holding companies. Potential investors would view this legislation negatively for several reasons. The first is the perception that management would not be subject to the same market discipline as other corporations and might not, therefore, provide competitive operating financial results. Second, the delay and uncertainty associated with an ICC review process will reduce prices paid in acquisitions. Finally, I believe that such legislation could potentially be viewed as a precursor to further industry regulation, which would reduce financial returns even further. The combination of these factors could well lead existing investors to sell their railroad equities, both initially and permanently lowering railroad stock prices and raising the cost of railroad capital.

Federal Railroad Administration Securities

I would like to turn for a moment to the subject of the government's investment in railroads through FRA securities. As we know, increased leverage at any company may translate into increased cost of debt or preferred securities, with an associated decline in the market value of those securities. I would propose that if the federal government has concern about the value and potential marketability of its own FRA securities that mechanisms other than the S.1005 legislation be considered. For example, on a case-by-case basis, the Department of Transportation could seek to renegotiate with railroads the terms and conditions of such securities to increase protection for the U.S. government's investment. Specifically, what is called "event risk" language could be added. Such a provision could require that the securities be repaid if the credit quality of the railroad company falls below a given level, typically investment grade or "BBB" ratings, or if debt should exceed a predetermined level. This is a provision that is becoming increasingly common in other corporate debt securities. Additionally, the seniority of these securities could perhaps be increased to the most senior levels to provide for the greatest degree of security. I have not reviewed the terms of existing FRA debt for the feasibility or legality of such modifications, but I would suggest that such a renegotiation strategy is a preferable alternative to S.1005 in addressing potential FRA concerns.

Conclusion

In conclusion, I am concerned that this first step to limit financial leverage in the railroad industry and establish capital standards may be like allowing the nose of the camel under the tent -- do we regulate railroad dividend policy next? Issuance of all public and private debt and equity securities? Stock repurchases? All capital structure issues in the railroad industry? And do we turn over to the ICC the determination of the appropriate level of capital investment in railroad companies? It seems to me that we have been down a similar path before. The overregulation that existed until the 1980's had much to do with the poor competitive and financial performance of U.S. railroads and the collapse or near collapse of many railroad carriers, including the demise of the Eastern rail system.

I would submit that this bill has the potential to spark exactly such additional reregulation, all of which will competitively disadvantage railroad companies in the marketplace and relative to other corporations in their costs and access to capital. Ultimately, increasing the cost of capital for all railroads will raise the cost of railroad service to shippers.

MORGAN STANLEY

MORGAN STANLEY & CO.
INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

August 10, 1989

The Honorable Ernest F. Hollings
Chairman, Committee on Commerce, Science and Transportation
United States Senate
Room SD-508
Dirksen Senate Office Building
Washington, D.C. 20510-6125

Dear Mr. Chairman:

As requested in your letter of July 13, 1989, attached is my response to your follow-up questions in connection with the Commerce Committee's June 22nd hearing on S.1005, Railroad Debt and Acquisition Issues. I hope you will find this helpful in your consideration of S.1005.

Please let me know if I can be of further assistance to the Commerce Committee in this matter.

Sincerely,

James A. Runde
Managing Director

SUBCOMMITTEE ON SURFACE TRANSPORTATION OF THE U.S. SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION
AUGUST 10, 1989

James A. Runde
Response to Commerce Committee Letter
dated July 13, 1989

Mr. Chairman, thank you for the opportunity to clarify my position regarding certain issues related to legislative bill S.1005. Specifically, you have asked for my response to the following questions:

> Current law requires ICC approval where one railroad seeks to purchase another railroad and where a non-carrier seeks to purchase two or more carriers, regardless of their size. In terms of a level playing field, do you see any compelling reasons why a non-carrier acquisition of a Class I carrier should be exempt from all ICC evaluation as to its plans for continued operation of the railroad? What if strict time limits were imposed on such a review?

The comparison between current law and proposed law should not involve the issue of achieving a level playing field, because one involves a change in market power and the other a change in ownership.

In the instance where one railroad seeks to purchase another railroad and where a non-carrier seeks to purchase two or more carriers, regardless of their size, there will occur a change in the competitive dynamics of the railroad industry. The combination of two existing railroads either through merger or purchase by a third party will, by definition, reduce the number of competitors in the industry. The rationale for regulatory review in this instance has been the desire to protect against excessive market power that could lead to reduced competition and abusive pricing power. Adoption of S.1005 or similar legislation addresses a distinctly different policy issue with respect to regulation of the railroad industry.

A non-carrier acquisition of a Class I carrier does not, by definition, reduce the number of competitors in the industry. Instead, it changes the ownership profile of one of the industry competitors, and this change in ownership is a capital structure issue, not a market power issue. I have previously argued that there is no sound rationale to reregulate the railroad industry's access to capital, even if strict time limits were imposed on such review.

I have also stated that the ICC's focus on the competitive issues related to the combination of two or more rail carriers is probably appropriate. The ICC, with its specialized knowledge and experience in the freight transportation sector in general, and the railroad industry in particular, is probably well qualified to conduct such a review and provide oversight of any anti-competitive or otherwise improper concentration of control of rail freight services in this country. One must consider, however, whether the expanded review of railroad financial and acquisition matters as proposed in S.1005 is first, necessary, and second, can be effectively implemented to accomplish its intended objective: determination of whether a given capital structure will adversely impact future rail service, to the detriment of shippers and the public.

As I stated in my testimony before the Commerce Committee in June, I believe that adoption of S.1005, or similar legislation, is unnecessary to ensure financial viability and adequate service levels in the railroad industry and will, in fact, produce negative consequences. Specifically, in my judgment, such legislation will impede railroads' access to capital and increase their capital costs, raise the cost of railroad service to shippers, and reduce the overall competitiveness of railroad companies relative to other modes of transportation. In addition, I do not believe there is a need to single out the railroad industry for regulation with respect to issues of financial leverage. In fact, deregulation of the U.S. railroad industry over the last ten years has contributed substantially to the financially healthy rail system we have today.

In my judgment, S.1005 is neither warranted nor justified. I believe that the best evidence of any company's financial viability is its access to debt and equity capital. Lenders to or investors in leveraged acquisitions, railroad or otherwise, carefully evaluate the ability of a company to remain financially healthy, balancing both operating and financial risk, prior to committing their capital. I would maintain, therefore, that access to capital is the best measure of financial viability in a proposed railroad acquisition -- or in any other acquisition. In addition, the ICC's current jurisdiction would seem to me to provide necessary oversight function with respect to a number of future operating and service decisions. For example, shippers and other interested parties may complain to the ICC if a rail carrier fails to maintain a line or a level of service. In certain circumstances the ICC can compel the sale of a line.

Whether the debt level in a proposed railroad acquisition will impair future rail service is inherently subjective and difficult to assess. The evaluation of any railroad's potential future quality of service involves significantly more than a review of financial ratios and statistics. A railroad's marketing strategy, operating efficiency, labor relations, maintenance policies, corporate culture, and leadership are all important determinants of the service provided by a railroad to its shippers, and ultimately the railroad's financial health. If, after conducting its review of an acquiror's proposed plans for operating a railroad, the ICC should determine them to be deficient in some respect, what remedy will be proposed? An ICC operating plan? Will the Board of Directors and management be handcuffed in the future by operating plans prescribed by the ICC at one point in time? Even if economic or business conditions warrant modification? Management and operating strategies are dynamic, not static. Finally, what measures would be implemented to protect against disclosure of confidential information contained in the operating plan?

In my judgment, the ICC is not equipped, in terms of resources and expertise, to address the single carrier capital structure, financial, and business issues addressed in this legislation. As I stated in my previous testimony, there are numerous examples of the significant delay which seems to be inherent in ICC review of financial and acquisition matters and the attendant adverse consequences. There is little evidence to suggest that a timely review of the issues contained in S.1005 could be accomplished. In my judgment, imposing a time limit on the ICC review process could mitigate, but not entirely eliminate, the aforementioned negative impact to the railroad industry of a potentially extended review process.

I conclude that adoption of S.1005 or similar legislation to review railroad financial and acquisition issues will not only competitively disadvantage railroads in accessing capital on attractive terms, and in their business marketplace, but raises a number of practical issues about the ICC's ability to effectively provide such an oversight function.

The **Chairman**. Mr. Runde, thank you very much. I have a few questions that I would like to ask of the entire panel, but let me start by asking a question first of Mr. Swartz.

Mr. Swartz, if I heard your testimony correctly, you said you doubted whether the ICC has the expertise that is necessary to make a judgment as they would be required to make under S. 1005.

Let me put the question to you this way. I do not know whether they have or not, but, if S. 1005 becomes law, I would hope that they would be in a position to retain the sufficient personnel that could make that determination. If that were true, would that alleviate, substantially, your concerns about S. 1005?

Mr. **Swartz**. No, it would not, Mr. Chairman. That is, I guess, kind of a side issue, but my real concern is what it does to rail equities in the longer term. And, the driving down of rail equities, I think, has some very serious impact on our industry and may actually lead to the very thing that I think this committee and the House committee is trying to avoid, and that is the opportunists that may buy in cheap and then use the assets of the company to get rich.

And, if they can buy in cheap because our equities have been driven down, it could lead to that.

The **Chairman**. I will ask anyone of you who wishes to to respond to the following questions. And, if you do not care to respond, then I would assume for the record that you would agree to with the answer that has been given by the other member of the panel.

My first question: If the use of leveraged buyouts grows in the railroad industry, do you feel that this may increase pressure for abandonments or the sale of branch lines by at least Class I carriers?

Mr. **Voytko**. I will take a stab at that, Mr. Chairman. I think the answer is yes, it will increase pressure for abandonments, but, with an important caveat. I think it will increase pressure for the abandonment of properties that are uneconomic and will be eventually abandoned anyway.

If somebody does a leveraged buyout of a railroad and there is a property that is producing cash-flow which this buyer must have to service his debt, this will be the last buyer who would want to abandon the property.

However, if the economics of that particular line are so poor that it is not making a contribution to the corporation and to its ability to service its debt, it is going to go faster than it would otherwise. So, the answer is yes, and it is a probably a healthy process as those resources can be shifted to areas where there is greater demand for service.

Mr. **Runde**. I would just add to that.

The **Chairman**. A healthy process, except for the people who live on the line.

Mr. **Voytko**. Well, I agree with you Mr. Chairman. But, I would point out again that, under the scenario I painted, it is inevitable. If it cannot be economically supported, it cannot be supported.

Mr. **Runde**. I would just add a couple of comments to that, Senator. Number one, the people who live on the line, in many cases across the country, have bought the line if it is not economic in and of itself. And, sometimes, labor has to participate in that.

The second thing I would say is that I think you know that abandonment procedures are subject to ICC review.

And, I think the third is, let us take the example of Conagra, somebody you are familiar with in Nebraska. I think that if I were Conagra and Mr. Harper, if I were running that company and I was told that to use the rail service in Nebraska I have got to subsidize the people who are not paying their fair share in terms of the cost of a branch line, I would think twice about using rail service. I think I would go to a truck service where I am not subsidizing other customers.

I think if I am Conagra I only want to pay my share. And if the other people cannot pay their share, then either Conagra is going to pay their share for them or it is going to go by truck.

The **Chairman**. Well, I would agree with you to a degree, Mr. Runde, but now we open up a whole new field. What is the rail system? What are feeder lines? What do they do during certain periods? What do they do during other periods? Has they been sufficient effort made by the local community and those who use the service to, on one hand, improve the service by the shippers, and on the other hand to increase advertising incentives in order to get more volume of traffic that could make that line profitable?

I guess what I am saying is that while there may be legitimate discussions as to whether or not lines should be abandoned that have not made money for a period of five or 10 years, you always have to look at the formulas that are used to make that determination.

Mr. **Voytko**. Might I add, Mr. Chairman, that it is ironic that the entrepreneurs most willing to try to make a go of economically troubled lines—that is short-line buyers—are heavy users of leverage, because they have to be.

And, so, to the extent that you give the Commission signals that you do not want to see leverage used by rail buyers, I think Mr. Runde would agree with me that there is certainly a significant portion of the short-line entrepreneurs who would like to keep rural America supplied with rail transportation who would be discouraged from doing so.

The **Chairman**. I would concede in asking the next question that, you know, which comes first, the chicken or the egg. But do you believe that cost associated with additional debt, especially some of the additional debt in the rates that we have indicated and talked about today in previous questions, are likely to result in increased rail rates for shippers?

Mr. **Swartz**. Since I did not get in on the last question, let me lead off on this one. I think the answer is no for two reasons.

One, really, we are so much now in a transportation marketplace that is competitively set that your debt structure really has nothing to do with what you can charge for the services you provide. In our case, between the deregulated part of our industry, and our contracts with shippers, about 80 percent of our business is not under regulation in any way; 20 percent still is. But I do not think there is any relation between our returns or our debt structure and what we are able to charge. It is set in the marketplace.

Second, I would argue, and I have to admit it has been a long time since I have taken basic finance and economics, but when I did, I was taught that equity is entitled to a greater return because people who put up equity money are taking more risk. And that generally returns on debt are lower than the returns that can be expected on equity.

So, if anything, if we have to get our returns up, it would be by reducing underleverage, too little use of debt, to give adequate returns to the equity holders, and not the reverse. There was a recent, fairly recent, within the last year, I meant to dig it out and I did not, but there was a tome written by someone at the ICC staff within the last year, criticizing railroads for not using enough debt and that hit home.

And I read it because Santa Fe Railway happens to be one that has less than 20 percent debt, and we still do. But I think the reverse is true, in the long run you have to provide your equity holders a greater return than your debt holders.

Senator **Exon**. Gentlemen, my last question for the record, and there may be one or two others that we would submit to you, and we would ask you to reply as promptly as you can to our questions, because we are trying to take a very thorough look at this piece of legislation. And my last question has to do with labor protection.

The ICC has testified that S. 1005 would require the imposition of mandatory labor protection in non-carrier acquisitions of Class I carriers. What are your views on that?

Mr. **Voytko**. I think labor protection is a bad idea. And I have always been puzzled by why the Congress is willing to extend labor protection to very specific classes of workers, like railway workers, but not to the millions of other hardworking people like those, for example, who work for Paine Webber. They are good people. Some of them are old and would be difficult to retrain. They are no less worthy as human beings than railroad workers. Some of them, believe it or not, even work in rural areas. And I think the same would hold true for Morgan Stanley or for any company.

We take risks as individuals working in a competitive economy. We get rewards for taking these risks. But I do not see the rationale for treating railroad workers differently, putting a big safety net under them and not under all the other hard-working Americans who are, I think, just as worthy human beings.

Senator **Exon**. Well, that is a very fine free enterprise statement. And I am not sure that everybody would agree with it. Let me ask you this, Mr. Voytko, right or wrong, the Staggers Act did make some recognition of that, so I would suggest to you, if for no other reason than because we have law to that effect.

Mr. **Voytko**. Well, I guess that is what I tell my kids all the time, that is the way I did it, and that is the way you have to do it, too.

I realize that is in the current law. I realize that there is a lot of case precedent, and I guess I ask for trouble here by saying that simply having used labor protection schemes in the past does not necessarily mean that it makes sense.

Mr. **Swartz**. If I could add to that. And I keep beating the same drum, but I think, again, that if there is a group of potential buyers of equity out there, whether it is a control buyer or simply someone who wants to buy in a major share—we have two 15 to 20 percent shareholders right now in our company—if they are fearful that by taking some action and buying stock they will either put our company under labor protection that it would not otherwise be under, or create some expense, we are going to drive those buyers out of the market place, and I think that would be bad for rail equities in the long run.

Senator EXON. My last question, then, has to do with the fact—do you who feel that labor protection should not be involved, also oppose golden parachutes in the corporate area?

Mr. SWARTZ. Generally, if you are looking at me, yes. I am just kind of an open, free enterpriser in that regard, although I will say, from the standpoint of our employees, I am not saying they do not have a legitimate interest in things like retraining or job protection. And these have been things that not only been covered under collective bargaining for years but, to my knowledge, are probably the most extensive and most generous in any industry. And whether we have employees laid off simply by downturns in the economy or the closing of the shop, all of those employees in the railroad industries are covered by various and sundry forms of negotiated labor protection.

Some of it matches what the ICC has given in the past. In some cases it may be less, in other cases it is more. So it is not a question of not having some concern for your employees.

Mr. VOYTKO. Your question hits home, Mr. Chairman, although I also am without a parachute. I am parachute-less. I think that what Mr. Swartz said is a good point. That is, if labor protection results because it is part of the contract, freely entered into between the work force and the owner, then that is fine. It is part of their compensation. And, indeed, if a board of directors and the shareholders want to attract a manager who says part of his agreement must be a parachute, then they can make the decision whether or not to do it.

I personally do not find it a good idea in general, but if it is freely entered into, and this is what the shareholders want in order to get this employee then I would not stand between them.

Senator EXON. Gentlemen, we thank you very much for coming and taking the time and being so patient. And, as I say, if you could answer the questions that we submit to you as quickly as you can, we would appreciate it very much.

And we are adjourned.

[Whereupon, at 4:15 p.m., the hearing was adjourned.]

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

REGIONAL RAILROADS OF AMERICA
324 Fourth Street, N.E.
Washington, D.C. 20002
202/543-0038

Senator James Exon 330 Hart Building Washington, DC 20510	Senator Robert Kasten 110 Hart Building Washington, DC 20510
Dear Senator Exon:	Dear Senator Kasten:

This is to comment on your hearing concerning S 1005 relating to the sale, purchase, or other acquisitions of Class I railroads. The Regional Railroads of America does not have a position on this legislation. However, we understand that representatives of railroad labor will testify in opposition to line sales by Class I railroads despite the fact that this is not the purpose of the hearing. Should such testimony be presented, we would ask that this letter and the attachment be included in the record together with the statement by the Railway Labor Executives' Association.

Line sales and spin-offs are an economic response to fundamental and long term changes in the railroad industry. They are an alternative to rail line abandonment which, prior to 1980 was the industry solution for ridding itself of light density lines that were a financial burden on an already declining industry. Abandonment results in huge reductions in employment and loss of rail service to countless communities across the country.

Deregulation, through the 1980 Staggers Act, provided competitive freedoms that created the potential for many of these marginal lines to be viable as stand alone entities. Recognizing this potential, the Interstate Commerce Commission adopted a policy which allowed line sales to go forward in a speedy fashion. Using its discretion under Section 10901 of the Interstate Commerce Act, the Commission refused to impose costly labor protection payments which could jeopardize the viability of new operations.

Since the passage of Staggers, some 200 new railroad companies operating nearly 16,000 miles of line have come into business. These new companies are the alternative to abandonment. By and large, these companies have been a success in preserving service for shippers in communities across America. These new companies have provided jobs. A random sample which included 47 percent of the RRA membership showed that 85 percent of the new regionals employed as many or more people at the end of 1988 as they did on their first day of operation. On an aggregated basis, employment has increased on the new regionals by an average of 4.8 percent a year. Since 1980, employment on the Class I railroads has decreased by 48.6 percent.

Regional railroad jobs are good jobs. Certainly wages on the smaller railroads are somewhat lower than on the Class I's in most cases. However, almost 70 percent of the new regional railroad companies surveyed have or are developing profit sharing plans for their employees. No Class I railroad has a profit sharing plan in place. On wages alone, a random sample of 22 RRA members demonstrate that wages average 28 percent higher than U.S. wide wages for all industries and 6 percent higher than wages in transportation, communications, and public utilities for the states served by the regional and local railroads. Our survey for the Supreme Court brief showed the weighted average annual wages for new regional railroad employees for 1988 to be $22,348.

The fact that regional and local carriers do not generally adopt Class I labor contracts does not mean that they do not work with organized labor to create attractive but affordable compensation packages. Many of the smaller, local railroads are not organized but most of the larger regional railroads are organized. Of the new regional railroads participating in the survey, 88 percent of their employees were unionized and thus these carriers negotiate with the unions to set rates of pay and work rules.

In recent years, rail labor has fought in Congress and the courts to impose labor protection payments as a condition of creating new companies and failing that, to subject the sales to strikes and the never ending provisions of the Railway Labor Act. The brotherhoods did win a victory in the Third Circuit Court of Appeals on the Pittsburgh and Lake Erie (P&LE) case. Since that case, line sales have almost come to a halt and there is evidence of growing abandonments.

The Supreme Court decided the P&LE case yesterday, June 21. RRA has not yet had an opportunity to evaluate the impact of that case. It does appear, however, upon first reading, that it will again be possible to complete line sales.

Commissioner Paul Lamboley has been conducting informal negotiations between management and labor on the line sale issue. RRA is participating in those negotiations in good faith. We are hopeful that these meetings will produce an agreement which will serve the legitimate interests of labor and management and allow the public interest in rail service preservation to be realized.

If the P&LE Supreme Court decision leaves issues unresolved, and labor and management cannot make an agreement on a line sale procedure, then RRA will support enactment of legislation similar to that introduced by Congressman Tom Tauke of Iowa.

RRA National Chairman, David Hughes, is making a statement today on the issue of labor protection and line sales at the annual meeting of the Regional Railroads of Minnesota at Brainerd, MN. That statement is attached and we ask that it also be included in the record.

Sincerely,

Ray

Ray B. Chambers
on behalf of
Regional Railroads of America

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SUMMARY OF RRA ISSUES FOR REGIONAL RAILROADS OF MINNESOTA

LABOR PROTECTION - LINE SALES

Federal law allows the imposition of mandatory, employer-funded jobless benefits to all railroad employees adversely affected by a consolidation, line sale or abandonment. Such protection can extend for as long as six years and covers salary, benefits, moving expenses, sale-of-home expenses and various allowances. Currently, employer-paid costs associated with past consolidations and abandonments exceed $355 million annually.

Rail labor has fought in the Congress and the Courts to impose labor protection payments on these new companies, and failing that to subject the sales to the never ending provisions of the Railway Labor Act. They were not successful in the 100th Congress, but did win a victory in the Pittsburgh & Lake Erie (P&LE) case at the U.S. Court of Appeals for the 3rd Circuit. Oral arguments took place on March 29 in the Supreme Court. The case was decided today, June 21. RRA has not had an opportunity to evaluate the decision. It appears that labor may not delay a sale by filing a Section 6 notice and that the duty to bargain ceases when an ICC order allowing the sale becomes effective. The Norris/LaGuardia question was remanded back to the lower courts. However, the Supreme Court did find that district courts have the power to enjoin strikes which violates specific provisions of the RLA.

The meaning of the Supreme Court decision is not yet fully clear. It is at least, however, a limited victory for management.

Line sales have come to a virtual halt since the P&LE decision. After six straight years of declining abandonments between 1982 and 1987, abandonments are now are on the rise. There has been a 58% increase since the P&LE decision. A recent survey submitted to the FRA indicates there are 17,000 miles of light density line the Class I railroads need to dispose of during the next 5 years. If they are not sold, they will be abandoned.

RRA has promoted legislation that would permit line sales to go forward. Congressman Tom Tauke (R-IA) introduced such legislation in the 100th Congress and reintroduced the RRA supported legislation in this Congress. The Ranking Republican on the Transportation Subcommittee of House Commerce, Bob Whittaker (R-KS) has also introduced a bill to resolve the line sale issue. Congressman Jim Slattery (D-KS) who, with Tauke, sits on the House Subcommittee on Transportation has called for a legislated solution in the event that rail labor and management cannot reach an accord outside of the Congress. Hearings are expected in the Luken House Subcommittee in July.

Interstate Commerce Commissioner Paul Lamboley has been conducting informal negotiations between management and labor on the line sale issue. A management proposal which is acceptable to the RRA and a labor proposal which is not acceptable have been exchanged. Lamboley intends to host an intensive two-day negotiation on June 29 and 30. Ray Chambers will participate for the RRA. If these negotiations are not a success, and the Supreme Court decision leaves major issues in doubt, RRA will push hard for legislation along the lines of the Tauke bill.

David Hughes
National Chairman, RRa
June 22, 1989